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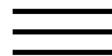

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Are banks too big to fail or too big to save? International evidence from equity prices and CDS spreads

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Abstract

Deteriorating public finances around the world raise doubts about countriesâ€™ abilities to bail out their largest banks. For an international sample of banks, this paper investigates the impact of bank size and government deficits on bank stock prices and CDS spreads. We find that a bankâ€™s market-to-book value is negatively related to the size of its liabilities-to-GDP ratio, especially in countries running large public deficits. CDS spreads appear to decrease with stronger public finances. These results suggest that systemically important banks can increase their value by downsizing or splitting up, especially if they are located in countries with weak public finances. We document that banksâ€™ average liabilities-to-GDP ratio reached a peak in 2007 before a significant drop in 2008, which could reflect these private incentives to downsize.

Highlights

â–º Bank market value negatively reflects bank size relative to GDP. â–º This effect is stronger in countries that run large deficits. â–º This evidence suggests that banks can be too large to save.

JEL classification

G21; G28

Keywords

Banking; Financial crisis; Credit default swap; Too big to fail; Too big to save

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