Abstract:
Based on total value of assets, the top 10% U.S. banks yield a 7.5% risk-adjusted return less than the bottom 10% per annum on average. A possible explanation is that the shareholders of large banks require lower return on their investment, since the equity of too-big-to-fail (TBTF) banks could be deemed as less risky due to possible implicit government guarantees. At the same time, such guarantees could amplify a moral hazard problem that induces TBTF banks to take riskier projects. Thus, if the additional risk borne by TBTF banks does not yield higher reward than other less risky projects undertaken by smaller banks, large banks could end up yielding a lower risk-adjusted return than their smaller peers. This raises the question whether the difference in risk-adjusted returns between big and small banks is reflective of an exante premium or an ex-post inefficient risk-taking? Proposing a unique diversification index to capture the risk-taking behavior of banks, we find robust evidence to support the latter view. Our findings indicate that TBTF subsidies not only disproportionately benefit large banks by granting them what amounts to a free insurance policy, but also distort the market in such a way that they incentivize large banks to take excessive risk and, hence, invest inefficiently.