Containing (or Restraining) Systemic Risk: The Need to Not Fail on ‘Too Big to Fail’

(With Reference to Margaret Thatcher, Geoffrey Howe, Irving Kristol, Joe Nocera, Bastiat, Nietzsche, Mencken and Sandy Weill)

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you, Steve (Beckner), for that kind introduction. This discerning audience no doubt noted that despite being overeducated, I am not a formally trained economist. I do not have a Ph.D. in economics; those who do will correctly deduce that I am somewhat "dismal" in comprehending the arcana of "the Dismal Science." After my undergraduate education in economics and my studies at Oxford, I took a different path. As Steve made clear, I earned an MBA and then went to Wall Street and into funds management before cashing out and taking to public service. My perspective on monetary policy and regulation is shaped less by theory and more by my experience as a market operator.

I confess that in matters of monetary policy and regulation, I am often in the minority. This does not make me the least bit uncomfortable. The majority opinion is not always right; indeed, my experience as an investor has biased me to conclude that more often than not, the consensus view is the wrong view, even among the most erudite. Steve kindly mentioned the timely contrarian advice I gave to the students at the R.I.S.E. student investment forum in Ohio in 2009. Exhibit A of the fallibility of consensus thinking is the herd mentality among supposedly sophisticated financiers as well as theoretical economists who believe in efficient-markets theory and other nonsense themes that led us into the recent financial crisis. I happen to believe that Margaret Thatcher, the former British prime minister, was right when she said, "You cannot lead from the crowd."[1] There is a role for contrarians, not just in the investment arena, but also at the highest level of policymaking; at a minimum, it is important to question and challenge consensus views, even when they are formed by the most credentialed individuals.

For example, some of you may recall the public letter written by 364 eminent economists predicting disastrous consequences that would result from Thatcher's policy initiatives. That letter was published in the *Times* of London on March 30, 1981.[2] The British economy began a recovery almost immediately afterward, in 1982; by 1983, inflation and mortgage rates were at their lowest levels in over a decade, while economic growth accelerated. The failure of the consensus view led Chancellor of the Exchequer Geoffrey Howe to define an economist as "a man who knows 364 ways of making love, but doesn't know any women."[3]

To be sure, economic theories and econometric models are of great utility for providing a framework for policymaking; we cannot make policy without them. But they are imperfect substitutes for common sense. The late New York intellectual Irving Kristol is reported to have said: "Don't fall for fantastical notions that have nothing to do with the way people really are."[4] My experience of having worked in real time in the financial markets leads me to a different perspective on financial operators and markets than that of most of my colleagues at the Federal Open Market Committee (FOMC). This not only affects my views on the implementation of monetary policy, but also shapes my perspective on regulation.

Monetary policy and regulation are intricately linked. When conducting its monetary policy, the Fed is governed by a dual mandate: creating the monetary conditions to foster maximum employment growth while constraining inflation and its alter ego, deflation. These goals cannot be realized without financial stability that results from effective regulation. As the FOMC now sets its sights on concluding the accommodative monetary policy it fashioned to stave off financial collapse and deflation, our supervision and regulation team is wrestling with developing the appropriate policy for dealing with the lingering effects of the financial crisis, and, most importantly, erecting a new regulatory framework to substantially reduce the chances of financial crises. Or at least make them more manageable, should one occur again. (In all candor, it would be more historically accurate to say "*when* one occurs again," because crises and panics have occurred repeatedly throughout history, including three times just in my own career: the mid-1970s, the late 1980s and just recently).

The Federal Reserve's efforts to revamp the regulatory framework are being led by Governor Tarullo, who is providing focused, important leadership on this critical matter.[5] The revamping.is largely shaped by the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd–Frank"), which became law last summer. The act establishes a new regulatory infrastructure for promoting financial stability. Among its most prominent macroprudential features is the Financial Stability Oversight Council, an interagency body charged with detecting and deterring threats to the financial system. The act also establishes an Office of Financial Research, a mechanism for the orderly winding down of failing financial firms, and new responsibilities for the Federal Reserve in overseeing certain nonbank financial companies and certain payment, clearing and settlement utilities. The Federal Reserve Board is also directed to develop enhanced prudential standards for large banking organizations and systemically important nonbank financial firms.

Dodd–Frank itself mostly provides only high-level direction, leaving an extraordinary number of details and critical decisionmaking to regulatory discretion. As a result, the ultimate nature and future of reform rest in the hands of regulators. As many of you are aware, the various regulatory agencies are presently seeking public comments on a range of issues involving implementation of Dodd–Frank.

Most regulatory reform initiatives applied since the Banking Act of 1864 have missed the mark. They looked good on paper and appeared to solve the problems of the day but later proved not up to the task. This is especially true with efforts to solve the "too big to fail" problem, in which an unwillingness to follow through on prior policy commitments to actually close down large failures and impose losses on their uninsured creditors has led to what economists call "time inconsistency" in policy. Let's hope this time will be different; that regulators will make their commitments credible and consistent with future rather than past needs.[6]

Having come from the financial industry, I take a keen interest in these issues, and I hold some strong opinions as to how we should proceed. I believe there are leverage points for effective reform. There are areas where, if regulators act decisively, they might have profound positive effects and avoid time inconsistency. Conversely, there are other areas where regulatory action would at best generate small benefits and, in the worst case, might actually be counterproductive.

The key to successful reform will be to identify the leverage points that exist and do our best to ensure regulators are up to the task in those areas while not burdening other aspects of the financial system with heavy intervention that might trigger the law of unintended consequences.

Eye on Target

Let us be clear about the goals of reform. With so much energy being expended on *the what*, *the when* and *the how* of implementing Dodd–Frank, the first risk we run is forgetting *the why*—the reasons for the act, its primary goals.

For this, we need only turn to the law itself, the preamble, which spells out the key objectives as follows: "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices and for other purposes."[7] On the subject of too big to fail, the legislation is quite blunt. The Conference Report summary of the legislation's key provisions, provided in plain English by the Senate Banking Committee, states that it seeks to end "the possibility that taxpayers will be asked to write a check to bail out financial firms that threaten the economy by: creating a safe way to liquidate failed financial firms; imposing tough new capital and leverage requirements that make it undesirable to get too big; updating the Fed's authority to allow system-wide support but no longer prop up individual firms; and establishing rigorous standards and supervision to protect the economy and American consumers, investors and businesses."[8]

While there is much to criticize about Dodd–Frank, I cotton to those blunt statements on ending too big to fail. For, if after the myriad rules and regulations are written and implemented we have not eradicated too big to fail from our financial infrastructure, reform will have failed yet again.

I have spoken to this topic on several occasions.[9] If you pull up a copy of the Sept. 28, 2009, *Wall Street Journal*, you will find an article I wrote with my colleague Harvey Rosenblum about the interference too big to fail poses for the effective conduct of monetary policy. In looking at regulatory reform and implementing Dodd–Frank, I think a key point worth repeating is that the distinction between "commercial banks" and "the shadow banking system" is a false one. The two became intertwined beginning with the bypassing of Glass–Steagall strictures by Sandy Weill and Citicorp and the deregulatory initiative of Gramm–Leach–Bliley. The fact is that the largest commercial banks played a major role in many of the more problematic phenomena of the recent credit boom and ensuing crisis, including the spread of what I have previously referred to as financial STDs, or securitization transmitted diseases.

In the aftermath of the Panic, these viruses linger. Last week, the *New York Times* printed an interesting article by Joe Nocera, who drew upon the observations of a highly regarded regional banker from Buffalo, Robert Wilmers of M&T Bank.[10] Wilmers claimed that of the $75 billion made by the six largest bank-holding companies last year, $56 billion derived from trading revenues. Nocera noted that "in 2007, the chief executives of the Too Big to Fail Banks made, on average, $26 million … more than double the compensation of the top nonbank Fortune 500 executives." A recent survey conducted for the *Wall Street Journal* of CEO compensation at 350 public companies shows that financial services compensation has been tempered; the rate of increase in compensation for 2010 was just 1 percent.[11] The *Journal* attributed this to higher levels of scrutiny of financial firms as well as pressure from shareholders and regulators. Even so, some financial-sector CEOs enjoyed robust increases in their total compensation, including a 74 percent increase and a 51 percent increase at two of the five largest U.S. banking organizations. Interestingly, the trading revenue of these two firms accounted for almost half of the $56 billion in total trading revenue mentioned by Mr. Wilmers. These recent numbers buttress Nocera's reasonable conclusion that bank CEOs "were being compensated in no small part on their trading profits—which gave them every incentive to keep taking those excessive risks."

I am sympathetic to these concerns. I have no problem with risk takers being rewarded with large compensation packages. I put my own and my partners' capital at risk for the 20 years I operated in the markets and profited handsomely. But I never was provided with capital that was safeguarded by government guarantees. There is no logic to having the public underwrite through deposit insurance or subsidize through protective regulation the risk-taking ventures of large financial institutions and their executives. There is a substantial case to be made for separating the "public utility"—or traditional core function of banking—from the risk-taking function.

To be sure, financial problems are not limited to large institutions and their complex, opaque and conflicted operations. Regional and community institutions that have for the most part stuck to the public utility function have faced their own difficulties, especially in the context of construction lending. But while over 300 banks failed during the crisis, another 7,000 did not. Community and regional banks that are not too big to fail appear to have succumbed less to the herdlike mentality and promiscuous financial behavior that affected their megabank peers.

Moreover, when smaller banks got into deep trouble, regulators generally took them over and resolved them. In the treatment of big banks, regulators, for the most part, tiptoed around them. Failing big banks were allowed to lumber on, with government support, despite the extensive damage they wrought. Big banks that gambled and generated unsustainable losses received a huge public benefit: too-big-to-fail support.

Postcrisis, the large institutions are even larger: The top 10 now account for 64 percent of assets, up from 58 percent before the crisis and substantially higher than the 25 percent they accounted for in 1990. In effect, more prudent and better-managed banks have been denied the market share that would have been theirs if mismanaged big banks had been allowed to go out of business. This strikes me as counter to the very essence of competition that is the hallmark of American capitalism: Prudently managed banks are being victimized by publicly subsidized competition from less-prudent institutions.

A student of existentialism is tempted to recall Nietzsche's lament that, "He who is punished is never he who performed the deed."[12] An acerbic devotee of H.L. Mencken might be given to recite his dictum that while "injustice is relatively easy to bear; what stings is justice."[13] I do not doubt for a New York minute that the savvy big players who "performed the deed" did so with confidence they would be protected by the authorities who might find "justice" difficult to impose. In solving the crisis at hand during the Panic, it appears that the most imprudent of lenders and investors were protected from the consequences of their decisions; the sinners were rescued and the virtuous penalized. In crafting regulations in response to Dodd–Frank, we need to restore market discipline in banking and let the market mete out its own brand of justice for excessive risk-taking rather than prolong the injustice of too big to fail.

It is not difficult to see where this dynamic, if uncorrected, will lead—to more pronounced financial cycles and recurring crises. I would argue that the failure to reform the banking system in Japan was one of the principal reasons for that country's "Lost Decade(s)." We must not let that pathology take hold here.

Making Matters Worse

If we do not keep this ultimate goal of reform firmly in mind, our rule making not only might fail to promote the original objectives of reform, but could actually work against them. Ironically, with Dodd–Frank, such a perverse outcome is a distinct possibility.

The Dodd–Frank law entails the writing of more than 200 proposals and rules covering a host of issues—risk-based capital requirements, ability-to-pay requirements for home mortgages, protections for consumers sending remittances to foreign countries and so on. The Congress decided the need for these rules to be written, drawing on the input of many, including some very thoughtful economists. Here, I think it wise to draw upon the insight of the classical liberal Frédéric Bastiat in his take on unintended consequences. Bastiat opined, "There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen."[14] The same might be said of regulators. As regulators grapple with implementation of the voluminous Dodd–Frank reform act, the unforeseen must be taken into account. The law of unintended consequences is always lurking in the shadows. To get regulatory reform right, we have a lot of "foreseeing" to do.

One can envision, for example, that the potential cumulative impact of the many regulations demanded by Dodd–Frank will be to artificially raise the cost structure of the non-too-big-to-fail depository institutions. Imposition of the new requirements and restrictions risks creating new economies of scale in banking generated by the costs of regulatory compliance, many of which could be fixed costs not fully proportional to bank size.

To the extent that a large scale becomes necessary to absorb the regulatory cost associated with reform, Dodd–Frank could intensify the tendency toward bank consolidation, resulting in a more concentrated industry, with the largest institutions predominating even more than in the past. Such an outcome would appear to me contrary to the stated spirit and goal of the act. A more consolidated industry would only magnify the challenge of dealing with systemically important institutions and offsetting their historically elevated too-big-to-fail status.

My concerns over regulation-induced economies of scale and the implications for industry consolidation apply to all the size classes of banks, given the extensive list of new or enhanced requirements created by Dodd–Frank and their associated compliance costs. As it affects community banking, my concerns are tempered somewhat, though not completely alleviated, by the small-bank exceptions that have been granted to several of the new law's more costly requirements.

Unfortunately, the same cannot yet be said for the case of regional banks. The act indicates that all banking organizations with more than $50 billion in assets should be subject to enhanced supervision. Some of the related regulatory proposals have already been distributed for comment.

Still other proposals for new, stricter "enhanced supervision" rules for these banks will be unveiled soon.

Yet, few really believe a $50 billion bank poses a systemic threat to our $17 trillion banking system. Nor is a $50 billion bank qualitatively similar along risk dimensions to the very largest ones that exceed $2 trillion in size. The top 10 banking organizations have a cutoff point of $300 billion. I posit that this group should constitute the primary target for enhanced supervision. Interestingly, despite its large share of industry assets, this group holds only about 20 percent of the small-business loans on bank books. Clearly, these institutions are engaged in substantial activities outside the traditional banking role. It is within these very largest banks, and perhaps a few slightly smaller yet highly complex or interconnected ones, that systemic risk is concentrated.

If the enhanced-supervision requirements are not highly graduated and imposed primarily on the very largest banks, it is not difficult to imagine how the costs associated with such supervision could lead mid-tier banks that exceed the $50 billion threshold—yet fall well short of megabank status—to seek merger partners in order to achieve sufficient scale by which to help cover the cost of regulation. This would compound the problem rather than alleviate it.

With regard to enhanced standards for such important factors as capital and liquidity requirements, leverage limits and risk management, Dodd–Frank instructs regulators to differentiate among these banks. Enhanced supervision can be implemented on a graduated scale, based on the extent of assets beyond $50 billion and possibly other factors. Let us do that fully, then, applying these measures along a highly graduated scale, with only minimal added mandates directed at mid-tier banking organizations.

However, when it comes to the top 10 or so, I would apply Dodd–Frank extensively and vigorously. I would apply all the elements of heightened supervision—from enhanced standards for capital and liquidity requirements, leverage limits and risk management to the additional measures of living wills and credit-exposure reports, concentration limits, extra public disclosures and short-term debt limits—with full force.

To this we would add robust annual stress tests conducted by the Federal Reserve, along with the additional tools and procedures of macroprudential supervision, including in-depth horizontal reviews across large companies.

Conclusion

I trust regulators will rise to the challenges posed by the financial crisis and too big to fail, leaving a legacy of success and providing a practicable infrastructure for next-generation supervision and regulation.

I quoted Bastiat's criterion for a good economist as one who accounts for "effects that must be foreseen." Economists did not do a good job of foreseeing the financial crisis. Neither did regulators. Moreover, previous measures directed at containing too big to fail proved ineffective, with no one too surprised that when crisis came, many large-bank counterparties were protected under implicit guarantees. Let's hope that going forward, regulators can do better, avoiding both unintended consequences and time inconsistencies. For if they don't, and they are unable to solve the too-big-to-fail issue in a timely manner, we will ultimately have to take more draconian measures and simply break up the largest banking organizations to eliminate the threat they pose to financial stability and economic growth.

That is my contrarian view, and I'm sticking with it.

Thank you.

Notes

[1] See www.number10.gov.uk/history-and-tour/prime-ministers-in-history/margaret-thatcher.
[2] See "Were 364 Economists All Wrong?" Institute of Economic Affairs, www.iea.org.uk/sites/default/files/publications/files/upldbook310pdf.pdf.
[3] See "Were 364 Economists All Wrong?" BBC Newsnight report by Stephanie Flanders, http://news.bbc.co.uk/2/hi/programmes/newsnight/4803858.stm.
[4] See "Three Cheers for Irving," by David Brooks, *New York Times*, Sept. 22, 2009.
[5] See "Regulating Systemically Important Financial Firms," address by Governor Daniel K. Tarullo at the Peterson Institute for International Economics, June 3, 2011.
[6] See "Financial Reforms or Financial Dementia," keynote address by Richard W. Fisher to the Southwestern Graduate School of Banking, June 3, 2010.
[7] See the Dodd–Frank Wall Street Reform and Consumer Protection Act, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.
[8] See "Restoring American Financial Stability," a summary of the bill, http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf.
[9] See "Paradise Lost: Addressing 'Too Big to Fail,'" speech by Richard W. Fisher at the Cato Institute's 27th Annual Monetary Conference, Nov. 19, 2009, and "Minsky Moments and Financial Regulatory Reform," speech by Richard W. Fisher before the 19th Hyman P. Minsky Conference, April 14, 2010. Also see note 5 and "The Blob That Ate Monetary Policy," by Richard W. Fisher and Harvey Rosenblum, *Wall Street Journal,* Sept. 28, 2009.
[10] See "The Good Banker," by Joe Nocera, *The New York Times*, May 30, 2011.
[11] See "Oil and Gas CEO Pay Beats Other Industries," by Dana Mattioli, *Wall Street Journal*, May 12, 2011. Also see http://graphicsweb.wsj.com/php/CEOPAY11.html.
[12] See *Daybreak: Thoughts on the Prejudices of Morality*, by Friedrich Nietzsche, Cambridge, U.K.: Cambridge University Press, 1997.
[13] See *Prejudices: Third Series*, by H.L. Mencken, New York: Alfred A. Knopf, 1922.
[14] See "That Which is Seen, and That Which Is Not Seen," in *Essays on Political Economy*, by M. Frédéric Bastiat, London: Provost & Co., 1872.