Taming the Too-Big-to-Fails: Will Dodd–Frank Be the Ticket or Is Lap-Band Surgery Required?

(With Reference to Vinny Guadagnino, Andrew Haldane, Paul Volcker, John Milton, Tom Hoenig and Churchill's 'Terminological Inexactitude')

Remarks before Columbia University's Politics and Business Club

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

New York City
November 15, 2011

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It is bracing to be with bright, young students here at the Politics and Business Club of Columbia University. I understand I have a high bar today: I need to surmount the heights reached in the insightful lecture recently given your undergraduate students by Vinny Guadagnino from the show *Jersey Shore*. I'll do my best.

Executive Summary

Today, I will speak to the issue of depository institutions considered "too big to fail" and "systemically important." I will argue that, just as health authorities in the United States are waging a campaign against the plague of obesity, banking regulators must do the same with regard to oversized banks that undermine the nation's financial health and are a potential threat to economic stability. I shall speak of the difficulty of treating this pernicious problem in a culture held hostage by concerns for "contagion," "systemic risk" and "unique solutions." I will posit that preoccupation with these concerns leads to an ethic that coddles survival of the fattest rather than promoting survival of the fittest, to the detriment of social welfare and economic efficiency.[1] I will express my hope that, properly implemented, the capstone of financial oversight, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank), might assist in reining in the pernicious threat to financial stability that megabanks or "systemically important financial institutions"—the SIFIs—have become. But I will also express concern about the difficulty of doing so, concluding with a suggestion that perhaps the financial equivalent of irreversible lap-band or gastric bypass surgery is the only way to treat the pathology of financial obesity, contain the relentless expansion of these banks and downsize them to manageable proportions.

The Problem with SIFIs

Aspiring politicians in this audience do not have to be part of the Occupy Wall Street movement, or be advocates for the Tea Party, to recognize that government-assisted bailouts of reckless financial institutions are sociologically and politically offensive; they stand the concept of American social justice on its head. Business school students here will understand that bailouts of errant banks are questionable from the standpoint of the efficient workings of capitalism, for they run the risk of institutionalizing a practice that distorts the discipline of the marketplace and interferes with the transmission of monetary policy.

To this last point, my colleague and director of research at the Dallas Fed, Harvey Rosenblum, and I have written about how too-big-to-fail banks disrupt the transmission of policy initiatives. I refer you to the article we jointly authored for the *Wall Street Journal* in September 2009, titled "The Blob That Ate Monetary Policy." Our thesis was that as their losses mounted, the too-big-to-fails, or SIFIs, were forced to cut back their lending and gummed up the nation's capital markets in general. Thus, before the Dodd–Frank Act was even proposed, we wrote that "guarding against a resurgence of the omnivorous TBTF Blob [must] be among the goals of financial reform."[2]

In previous speeches I have taken note of another dimension to the problem of sustaining behemoth financial institutions, and that is the cost of doing so. Andrew Haldane, executive director for financial stability and a member of the Financial Policy Committee at the Bank of England, provides some rough estimates of the subsidy that flows to banks from governments following a too-big-to-fail policy. With markets working under the assumption that they will invariably be protected by government, the cost of funds is measurably less, according to Haldane's work, giving them preferential access to investment capital. He estimates the global subsidies enjoyed by the too-big-to-fails in 2009 ranged up to a staggering $2.3 trillion.[3]

Thus, I argue that sustaining too-big-to-fail-ism and maintaining the cocoon of protection of SIFIs is counterproductive, expensive and socially questionable.

As students, you should know that financial booms and busts are a recurring theme throughout history and that bankers and their regulators suffer from recurring amnesia. They periodically forget the past and all the lessons of history, tuck into some new financial, quick-profit fantasy—like the slicing and dicing and packaging of mortgage financing—and underestimate the risk of growing into unmanageable and unsustainable size, scale and complexity as they overindulge in that new financial fantasy. Invariably, these behemoth institutions use their size, scale and complexity to cow politicians and regulators into believing the world will be placed in peril should they attempt to discipline them. They argue that disciplining them will be a trip wire for financial contagion, market disruption and economic disorder. Yet failing to discipline them only delays the inevitable—a bursting of a bubble and a financial panic that places the economy in peril. This phenomenon most recently manifested itself in the Panic of 2008 and 2009.

Paul Volcker states the problem thus: "The greatest structural challenge facing the financial system is how to deal with the widespread impression—many would say conviction—that important institutions are deemed 'too large or too interconnected' to fail."[4]

Paul 'Moses' and John Milton

On previous occasions, I have referred to Paul Volcker as the Moses of central bankers. He is an iconic figure who led us out of the desert of inflation and economic stagnation in the 1980s. Mr. Volcker is a man of principle and probity; is selfless and indifferent to financial gain; and is wise to the political shenanigans of powerful lobbies that perpetuate structural distortions that interfere with the public good. (In short, he is the perfect stuff of a central banker.) Most importantly, he understands the necessity of allowing for failure as a part of the process of creative destruction, especially so in the world of finance.

Having referred to Moses, I trust that in this academic setting, I might be forgiven if I draw upon one of my favorite literary references to failure, albeit one that is other-worldly. In *Paradise Lost*, John Milton has God telling us why he created men and angels, both of whom could betray Him:

"…I made [mankind] just and right,

Sufficient to have stood, though free to fall.
Such I created all th' ethereal Powers
And Spirits, both them who stood and them who failed;
Freely they stood who stood, and fell who fell…"[5]

Milton considered the issue of failure on a much higher plane than the realm of bank regulatory policy. But the principle, expressed in that stanza of his paean to God's creation of the "ethereal Powers," applies equally to banking. Banks are created and given powers as mechanisms of credit intermediation, in order to allow an economy to grow and become prosperous. Yet, if regulators—who oversee the creation of banks and monitor their business—can't secure capital structures at our largest financial institutions that are "just and right," and do not allow for institutions that "betray" their creators to be "free to fall," it is unlikely those financial institutions will fulfill their proper intermediary role and be agents of economic prosperity.

Thus far, regulators have failed in their mission of warding off betrayal.

Perpetuating Obesity

With each passing year, the banking industry has become more concentrated. Half of the entire banking industry's assets are now on the books of five institutions. Their combined assets presently equate to roughly 58 percent of the nation's gross domestic product (GDP). The combined assets of the 10 largest depository institutions equate to 65 percent of the banking industry's assets and 75 percent of our GDP.

Some of this ongoing consolidation is the result of a dynamic set in place by Congress' passage of interstate branching legislation in 1994 and repeal of Glass–Steagall provisions in 1999. But some of it also reflects the result of the recent financial crisis. When difficulties began to appear at large financial institutions, resolution policies often entailed their merger or acquisition with other large institutions. Add to this the regulatory forbearance and financial backstops that tend to be granted to the largest banks in exigent circumstances, and the end result is a few financial behemoths, each with well over a trillion dollars in assets and a heavy concentration of power. In fact, the top three U.S. bank holding companies each presently have assets of roughly $2 trillion or more.

Of course, problems in the banking sector have not been exclusively confined to large financial institutions. Regional and community banks have faced their own problems, especially connected to construction lending. But here is the rub: When smaller banks get in trouble, regulators step in and resolve them. The term "resolve" in the context of smaller banks is a fancy way of saying their demise was quickly and nondisruptively arranged—they were disposed of. We might have expected equal treatment of big banks, but, of course, that did not happen.[6] To be sure, some very large financial firms have ceased to exist or have been through a corporate reorganization with some of the characteristics of a Chapter 11 bankruptcy. But these institutions deemed "too big to fail," and deemed to be "systemically" important due to their size and complexity, were given preferential treatment. Many were absorbed by still larger financial institutions, thus perpetuating and exacerbating the phenomenon of too big to fail.

This problem of supersized and hypercomplex banks is not unique to the United States. Europe is struggling today with how to cushion its megabanks from excessive exposure to intra-European sovereign debt. And Japan is still feeling the negative impacts of not successfully resolving the financial difficulties at its megabanks two decades ago.

A Perverse Lake Wobegon

Why are too-big-to-fail institutions treated differently than smaller banks? Even Vinny Guadagnino knows the obvious answer to that question: In a system of large and/or interconnected banks, difficulties at one institution can easily spill over and take down other banks or even the entire industry. Fear of "systemic risk" conditions the treatment of financial behemoths.

In today's interconnected, globalized financial system, systemic risk is more pronounced than ever. And we know that when a systemic crisis occurs—as it did in the Panic of 2008–09—the results can be catastrophic to the economy. Small wonder that in commenting on the problems currently besetting Europe, the U.S. Treasury secretary recently stated, "The threat of cascading default, bank runs and catastrophic risk must be taken off the table."[7] This has become dogma among banking regulators and their minders. Thus, in the recently announced Greek bond deal, the Euro Summit Statement tells us that "Greece requires an exceptional and unique solution."[8]

Such a solution is certainly in the interest of American bankers. In Saturday's *New York Times*, it was reported that the Congressional Research Service has estimated that the exposure of U.S. banks to Portugal, Italy, Ireland, Greece and Spain amounted to $641 billion; American banks' exposure to German and French banks was in excess of an additional $1.2 trillion. According to the Bank for International Settlements, U.S. banks have $757 billion in derivative contracts and $650 billion in credit commitments from European banks. Thus, the Congressional Research Service concluded that "a collapse of a major European bank could produce similar problems in U.S. institutions."[9]

In the land of the too-big-to-fails, we find ourselves in something akin to a perverse financial Lake Wobegon: All crises are "exceptional," and all require "unique solution(s)."

Yet, it seems to me that in our desire to avoid "cascading default" and "catastrophic risk," and in our search for "exceptional and unique solution(s)," we may well be compounding systemic risk rather than solving it. By seeking to postpone the comeuppance of investors, lenders and bank managers who made imprudent decisions, we incur the wrath of ordinary citizens and smaller entities that resent this favorable treatment, and we plant the seeds of social unrest. We also impede the ability of the market to clear or, to paraphrase Milton, allow the marketplace to distinguish "freely" those who should stand and those who should fall.

Enter Dodd–Frank

I said earlier that financial crises are nothing new. Nor is the response to them: a flurry of legislation that ends up giving more power to regulators in the hope of preventing the next crisis. The Glass–Steagall Act was enacted during the Great Depression, the FDIC Improvement Act after the banking and savings-and-loan troubles in the late 1980s. And now, in response to the Panic of 2008–09, we are implementing the Dodd–Frank Act.

Dodd–Frank—which is over 2,000 pages long, contains 16 titles, 38 subtitles and a total of 541 sections—is the most complex document ever written in the history of efforts to change the financial regulatory landscape. A cheeky historian might recall French Prime Minister Georges Clemenceau's reaction to Woodrow Wilson's 14 points, proposed as a safeguard for world peace after World War I: Clemenceau is reported to have thought that God did a pretty good job with only 10.

Whether it is through 10 commandments or 14 points, or over 2,000 pages, the question is: Does Dodd–Frank appropriately confront systemic risk and the associated problem of too big to fail? Its preamble certainly states a desire to do so, declaring boldly that its purpose is to "end 'too big to fail'" and "protect the American taxpayer by ending bailouts."[10]

Dodd–Frank does, in fact, contain a number of measures that attempt to address too-big-to-fail-ism. It creates a Financial Stability Oversight Council—or FSOC—composed of the major financial-sector regulators charged with overseeing the entire financial system. The FSOC can recommend that important nonbank firms be brought under the regulatory umbrella. Those who will be brought under that umbrella will be subjected to periodic stress tests to make sure they can withstand reversals in the economy and other adverse developments. Dodd–Frank calls for enhanced capital requirements for SIFIs. And it provides for a new authority for resolving bank holding companies and other financial institutions that wasn't available to authorities during the recent crisis.

Implementing Dodd–Frank

Will it work? Will Dodd–Frank achieve the desired goals declared in its preamble? The devil, as always, is in the details of how the legislation is implemented.

At the most basic level, the legislation leaves many of the details to rulemakings by various regulatory agencies; more than one year after enactment, there is still much work to be done in actually implementing the act. On Nov. 1, the law firm of Davis Polk & Wardwell released its monthly progress report on Dodd–Frank implementation. According to that report, of the 400 rulings required by the legislation, 173, or roughly 43 percent, have not yet been proposed by regulators. Of the 141 rulemakings required of bank regulators—the Federal Reserve, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currencey—58, or about 41 percent, have not yet been proposed.[11]

Capital Requirements and an Atomic Reaction

While acknowledging that the specific regulations spawned by Dodd–Frank have yet to be perfected, one of the harshest criticisms of its treatment of SIFIs has come from my former colleague and president of the Kansas City Fed, Tom Hoenig, who is now the nominee to be vice chair of the FDIC. He has argued that the very existence of SIFIs is "fundamentally inconsistent with capitalism" and "inherently destabilizing to global markets and detrimental to world growth."[12] Moreover, according to Mr. Hoenig—who had unquestionably the greatest depth of regulatory experience of all the Federal Reserve presidents and governors—even with the completion of Dodd–Frank, the existence of too-big-to-fail institutions will likely remain and "poses the greatest risk to the U.S. economy."[13]

One might counter that the enhanced capital requirements envisioned by Dodd–Frank—being negotiated presently by the Fed and other regulators nationally and internationally—will be a fitting treatment for too-big-to-fail-ism. In theory, it certainly sounds good. But as Paul Volcker has pointed out, "That's an old story."[14] We've had a system of international risk-based capital requirements in place for some time under the auspices of the Bank for International Settlements, beginning with Basel I in the early 1990s. That morphed into Basel II in the early 2000s, and now we are introducing Basel III. In fact, in the U.S., we can go all the way back to the National Bank Act of 1864 to find a system of capital requirements on banks.

Capital requirements are indeed important. A strong capital base protects a business when times get tough, giving it reserves to draw upon so that it can wait out a storm. Applied to banks, it also should mitigate risk-taking incentives that are an inevitable by-product of our too-big-to-fail system: If you put meaningful shareholder money directly at risk, managers of banks beholden to those shareholders will be less tempted to take pie-eyed risks.[15]

The operative word in the previous sentence is "meaningful." The existing regulatory measures were found wanting on measures of meaningful capital. For example, at the height of the crisis in mid-2008, two of the largest, most troubled institutions—Citigroup and Bank of America—were considered "adequately capitalized" (or even higher), according to the then-prevailing regulatory criteria. The Belgian bank Dexia is another case in point. In a press release issued just last May, it highlighted its regulatory capital ratio of 13.4 percent as "confirming our Group's high level of solvency."[16]

Winston Churchill used the phrase "terminological inexactitude" to suggest a certain lack of directness; one might easily conclude that there was some "inexactitude" surrounding the capital structures of Citi, Bank of America and Dexia.

I return to Andrew Haldane of the Bank of England. Haldane makes an intriguing parallel between the financial system and epidemiological networks. Conventional capital requirements seek to equalize failure probabilities across institutions to a certain threshold, say 0.1 percent. But using a systemwide approach would result in a different calibration, if the objective were to set a firm's capital requirements equal to the marginal cost of its failure to the system as a whole. Regulatory capital requirements would then be higher for banks posing the greatest risk to the system, which is what Dodd–Frank proposes, and what the current Basel III requirements are also considering.

To Haldane, this is a new approach in banking, but not in epidemiology where "focusing preventive action on 'super-spreaders' within the network to limit the potential for systemwide spread" is the norm. As Haldane emphasizes, "If anything, this same logic applies with even greater force in banking."[17] To me, treating too-big-to-fail institutions as potential "super-spreaders" of financial germs has a great deal of appeal.

The latest round of international capital standards is seeking to correct for "terminological inexactitude" and tighten up the definition of what banks can count as capital, so as to prevent "super-spreading." That's good news. Yet, this effort is being met with fierce resistance from the SIFIs. Tom Hoenig once suggested that when regulators begin the process of tightening up the latitude granted the megabanks, they will find themselves "facing an atomic force of resistance."[18] He appears to have been spot on. The head of one of the major U.S. financial institutions has called these new proposals "anti-American."[19] Last Thursday, the *Wall Street Journal* wrote of "bankers seething over rising … capital requirements."[20] Such is the intensity of emotion to resist the work of the Fed and other regulators as they seek to protect the system from the pernicious risk inherent in the existence of megabanks.

We cannot let that resistance prevail.

And we must insist, as Dodd–Frank does, that SIFIs be required to submit a "living will" that describes their orderly demise. Credit exposure reports must also be submitted periodically to estimate the extent of SIFI interconnectedness. We must see to it that the FDIC "ensure(s) that the shareholders of a covered financial company … not receive payment until after all other claims … are fully paid."[21] This is essential to restoring the discipline of the marketplace and is what the Fed expects to achieve when it finalizes its work on Section 165 and other aspects of the legislation, as discussed last week by Vice Chair Janet Yellen in a speech in Chicago.[22]

An Achilles' Heel

For all that it specifies to treat the unhealthy obesity and complexity of too-big-to-fails, Dodd–Frank has an Achilles' heel. It states that in the disposition of assets, the FDIC shall "to the greatest extent practicable, conduct its operations in a manner that … mitigates the potential for serious adverse effects to the financial system."[23] This is entirely desirable; nobody wants to initiate serious financial disruption. But directing the FDIC to mitigate the potential for serious adverse effects leaves plenty of wiggle room for fears of "cascading defaults" and "catastrophic risk" to perpetuate "exceptional and unique" treatments, should push again come to shove.

I may be excessively skeptical on this front. Vigilantes of the bond and stock market, of which I was once a part, have been demanding greater transparency in reporting the exposures of the megabanks, including a more fulsome account of both gross and net exposures of credit default swaps. And Moody's has recently downgraded the long-term debt of major U.S. and U.K. banks. This is oddly reassuring. Moody's said that "actions already taken by U.K. authorities have significantly reduced the predictability of support over the medium to long term,"[24] whereas in the U.S., it found "a decrease in the probability that the U.S. government would support [major banks]."[25]

Of course, the ratings agencies did not exactly cover themselves in glory during the crisis. Let's hope their assessment of at least somewhat more limited government support for the megabanks proves more accurate than the triple-A ratings they gave to so many mortgage-backed securities.

The Alternative: Radical Surgery

In short, progress is being made in the direction of treating the pathology of SIFIs and the detailing of enhanced prudential standards governing their behavior. Yet, in my view, there is only one fail-safe way to deal with too big to fail. I believe that too-big-to-fail banks are too-dangerous-to-permit.[26] As Mervyn King, head of the Bank of England, once said, "If some banks are thought to be too big to fail, then … they are too big." I favor an international accord that would break up these institutions into more manageable size. More manageable not only for regulators, but also for the executives of these institutions. For there is scant chance that managers of $1 trillion or $2 trillion banking enterprises can possibly "know their customer," follow time-honored principles of banking and fashion reliable risk management models for organizations as complex as these megabanks have become.

Am I too radical? I think not. I find myself in good company―Paul Volcker, for example, advocates “reducing their size, curtailing their interconnectedness, or limiting their activities.”[27]

In my view, downsizing the behemoths over time into institutions that can be prudently managed and regulated across borders is the appropriate policy response. Then, creative destruction can work its wonders in the financial sector, just as it does elsewhere in our economy.

We shouldn’t just pay lip service to letting the discipline of the market work. Ideally, we should rely on market forces to work not only in good times, but also in times of difficulties. Ultimately, we should move to end too big to fail and the apparatus of bailouts and do so well before bankers lose their memory of the recent crisis and embark on another round of excessive risk taking. Only then will we have a financial system fit and proper for servicing an economy as dynamic as that of the United States.

Thank you.

Notes

[1] I am thankful to Andrew Haldane of the Bank of England for coining this phrase. “Systemic Risk in Banking Ecosystems,” by Andrew G. Haldane and Robert M. May, *Nature*, Jan. 20, 2011, pp. 351–55.

[2] “The Blob That Ate Monetary Policy,” by Richard W. Fisher and Harvey Rosenblum, *Wall Street Journal*, Sept. 28, 2009.

[3] “Control Rights (and Wrongs),” speech by Andrew G. Haldane, executive director for financial stability and member of the Financial Policy Committee, Bank of England, Oct. 24, 2011, Table 1.

[4] “Three Years Later: Unfinished Business in Financial Reform,” by Paul Volcker, the William Taylor Memorial Lecture, Sept. 23, 2011, Washington, D.C., p. 8.

[5] *Paradise Lost*, Book III, by John Milton, New York: W.W. Norton and Co., 1993, lines 98–102.

[6] “Financial Reform or Financial Dementia?,” speech by Richard W. Fisher, June 3, 2010.

[7] Statement by Treasury Secretary Timothy F. Geithner, 24th Meeting of the International Monetary and Financial Committee, Sept. 24, 2011, U.S. Department of the Treasury, Press Center.

[8] See “Euro Summit Statement,” Brussels, Oct. 26, 2011, p. 5.

[9] “European Turmoil Could Slow U.S. Recovery,” by Annie Lowrey, *New York Times*, Nov. 12, 2011.

[10] 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.

[11] See “Dodd–Frank Progress Report,” Davis Polk & Wardwell, November 2011, www.davispolk.com/files/Publication/e3379fb6-ab9d-4ed8-b873-0877696a8005/Presentation/PublicationAttachment/690130be-02e6-4037-88e8-01648c94664f/November2011_Dodd.Frank.Progress.Report.pdf.

[12] “Do SIFIs Have a Future?,” speech by Thomas M. Hoenig, president and chief executive officer, Federal Reserve Bank of Kansas City, July 27, 2011.

[13] “Financial Reform: Post Crisis?,” speech by Thomas M. Hoenig, president and chief executive officer, Federal Reserve Bank of Kansas City, Feb. 23, 2011.
[14] See note 4, p. 5.
[15] Given the opacity of bank balance sheets and the arcane accounting practices whereby very similar assets can be valued differently in many circumstances, the discipline imposed on bank managers by shareholders has been limited, in both megabanks and smaller banks.
[16] “Net Profit of EUR 69 Million in 1Q2011. Strong Operational Performance by the Commercial Business Lines. Transformation Plan Ahead of Schedule,” Dexia press release, May 11, 2011.
[17] See note 1.
[18] “It’s not Over ’Til It’s Over: Leadership and Financial Regulation,” speech by Thomas M. Hoenig, president and chief executive officer, Federal Reserve Bank of Kansas City, Oct. 10, 2010.
[19] “JPMorgan Chief Says Bank Rules ‘Anti-US,’” by Tom Braithwaite and Patrick Jenkins, *Financial Times*, Sept. 11, 2011.
[20] “Fed Governor Allays Banks,” by Victoria McGrane, *Wall Street Journal*, Nov. 10, 2011.
[21] Dodd–Frank Act, Section 206.
[22] “Pursuing Financial Stability at the Federal Reserve,” speech by Janet Yellen, vice chair of the Federal Reserve Board of Governors, Nov. 11, 2011, www.federalreserve.gov/newsevents/speech/yellen20111111a.htm.
[23] Dodd–Frank Act, Section 210.
[24] “Rating Action: Moody’s Downgrades 12 UK Financial Institutions, Concluding Review of Systemic Support,” Moody’s Investors Service, Oct. 7, 2011.
[25] “Rating Action: Moody’s Downgrades Wells Fargo & Company Rating,” Moody’s Investors Service, Sept. 21, 2011 (similar releases appeared on the same date for Citigroup and Bank of America).
[26] See “Lessons Learned, Convictions Confirmed,” speech by Richard W. Fisher, March 3, 2010, and “Minsky Moments and Financial Regulatory Reform,” speech by Richard W. Fisher, April 14, 2010.
[27] See note 4, p. 9.