Ending ‘Too Big to Fail’

Remarks before the Conservative Political Action Conference

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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, Chad [Barth].

I gather you all held a big dinner last night in honor of Ronald Reagan. My father-in-law, the late Congressman Jim Collins, was a good friend of the president. During the Convention of 1984, which was held in Dallas, Congressman Collins invited me to join a handful of family and friends to visit with Mr. Reagan. The president was in remarkable form and, great raconteur that he was, told this story:

Paddy McCoy, a hardworking Irish farmer, received a visit from an inspector of the Department for Works and Pensions.

“Tell me about your staff,” he asked of Paddy.

“Well,” said Paddy, “there are the farmhands. I pay them 240 a week and they have use of a free cottage.”

“That’s good,” said the inspector.

“Then there’s the housekeeper. She gets 190 a week, along with free board and lodging.”

“That sounds fine,” said the inspector.

Paddy went on to tell of the rest of his staff, all to the pleasant reception of the inspector. And then he said, “Now, there’s also the half-wit. He bears all the risk of this business, works a 16-hour day, nets about 25 a week when all is said and done, but takes down a bottle of whiskey and, as a special treat, occasionally gets to sleep with my wife.”

“That’s disgraceful, Paddy,” said the inspector. “I need to interview the half-wit.”

“Well,” said Paddy, “you’re lookin’ at him.”

Paddy McCoy was no half-wit: He simply represented the plight of the hardworking souls who want to be left alone to labor day and night to put food on the table for their employees and family. They ask for no advantage, just a level playing field and fair treatment. I am here today to speak of the plight of hardworking Main Street bankers who simply want to be given a level playing field and fair treatment in competing with megabanks.

Chad, the last time I spoke to an audience here in the nation’s capital, I was introduced by a descendant of the iconic patriot Patrick Henry.

In one of Patrick Henry's greatest speeches, he noted that, "Different men often see the same subject in different lights." And then he went on to appeal to all perspectives to do right: "This is no time for ceremony," he said, for it "…is one of awful moment to this country."

The great patriot was, of course, addressing the injustice of operating under the thumb of the British Crown. This morning, I am going to address what I consider the injustice of operating our economy under the thumb of financial institutions that are so large they are considered "too big to fail" (TBTF).

I will argue that these institutions operate under a privileged status that exacts an unfair tax upon the American people.

I will argue that they represent not only a threat to financial stability but to fair and open competition, that they are the practitioners of crony capitalism and not the agents of democratic capitalism that makes our country great.

I will argue that by the attorney general's own admission their privileged status places them above the rule of law.

I will argue that the effort crafted by Congress to correct the problems of TBTF—known as the Dodd–Frank Act—is, despite its best intentions, counterproductive and needs to be changed, that it is an example of the triumph of hope over experience.

And, last, I will argue that dealing with TBTF is a cause that should be embraced by conservatives, liberals and moderates alike. For regardless of your ideological bent, there is no escaping the reality that TBTF banks' bad decisions inflicted harm upon the American people during the "awful moment" of the 2008–09 crisis. The American people will be grateful to whoever liberates them from a recurrence of taxpayer bailouts.

Now, Federal Reserve convention requires that I issue a disclaimer here: As always, I speak only for myself, not for others associated with our nation's central bank. That usually is abundantly clear. It will be especially so today. There are different views on this issue within the Fed; like Patrick Henry's co-patriots, we "see the same subject in different lights." The chairman of the Fed, Ben Bernanke, and at least two other governors, Daniel Tarullo and Jerome Powell, all good friends and men I greatly admire, have different views than ours in Dallas about how to address the problem of TBTF. You should consider their views.[1] Today, I'll simply give you mine.

Here are the facts: A dozen megabanks today control almost 70 percent of the assets in the U.S. banking industry. The concentration of assets has been ongoing, but it intensified during the 2008–09 financial crisis, when several failing giants were absorbed by larger, presumably healthier ones. The result is a lopsided financial system.

Today, these megabanks—a mere 0.2 percent of banks, deemed candidates to be considered "too big to fail"—are treated differently from the other 99.8 percent and differently from other businesses. Implicit government policy has made the megabank institutions exempt from the normal processes of bankruptcy and creative destruction. Without fear of failure, these banks and their counterparties can take excessive risks.

Their exalted status also emboldens a sense of immunity from the law. As Attorney General Eric Holder frankly admitted to the Senate Judiciary Committee on March 6, when banks are considered too big to fail, it is "difficult for us to prosecute them … if you do bring a criminal charge, it will have a negative impact on the national economy."[2]

The megabanks can raise capital more cheaply than can smaller banks. Studies, including those published by the International Monetary Fund and the Bank for International Settlements, estimate this advantage to be as much as 1 percentage point, or some $50 billion to $100 billion annually for U.S. TBTF banks, during the period surrounding the financial crisis.[3] In a popular post by editors at Bloomberg, the 10 largest U.S. banks are estimated to enjoy an aggregate longer-term subsidy of $83 billion per year.[4]

Andy Haldane, executive director for financial stability at the Bank of England, estimates the current implicit TBTF subsidy to be roughly $300 billion per year for the 29 *global* institutions identified as "systemically important."[5]

Given this range of estimates, Senators [Sherrod] Brown of Ohio and [David] Vitter of Louisiana have asked the Government Accountability Office (GAO) to calculate just how much of a cost-of-funds advantage the big banks have over the 5,570 banking organizations that make up the 99.8 percent that are *not* too big to fail.

As pointed out in Thursday's *New York Times* blog by Simon Johnson, the noted MIT economist, all one has to do is ask people in the credit markets if they think lenders to the biggest banks have some degree of protection offered by the government, and you will hear a resounding yes![6]

At the Dallas Fed, we believe that whatever the precise subsidy number is, it exists, it is significant, and it allows the biggest banking organizations, along with their many nonbank subsidiaries (investment firms, securities lenders, finance companies), to grow larger and riskier.

This is patently unfair. It makes for an uneven playing field, tilted to the advantage of Wall Street against Main Street, placing the financial system and the economy in constant jeopardy.

It also undermines citizens' faith in the rule of law and representative democracy.

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act was a well-intentioned response to the problem. However, its stated promise—to end too big to fail—rings hollow. Running 849 pages and with more than 9,000 pages of regulations written so far to implement it, Dodd–Frank is long on process and complexity but short on results.

Regulators cannot enforce rules that are not easily understood.

Nor can they enforce these rules without creating armies of new bureaucrats. Congress's Financial Services Committee aggregates information from the Federal Register that estimates the cumulative hours needed for the affected agencies, like the Fed, to fulfill new requirements called for by Dodd–Frank. The committee presently estimates that it will take 24,180,856 hours each year to comply with new rules already finalized for implementation of the act.[7] And we have yet to complete the rulemaking process!

I work every day with my colleagues at the Fed to craft the monetary conditions to help the economy create jobs. This is not the kind of job creation I would hope for.

Further, despite the plethora of new rules and regulations created by Dodd–Frank, market discipline is still lacking for the largest dozen or so institutions, as it was during the last financial crisis. Why should a prospective purchaser of bank debt practice due diligence if, in the end, regardless of new layers of regulation and oversight, it is widely perceived that the issuing institution will not be allowed to fail?

The return of marketplace discipline and effective due diligence of banking behemoths is long overdue. My colleagues and I at the Dallas Fed offer a modest proposal to that end, with a goal of leveling the playing field for all.

First, we would roll back the federal safety net—deposit insurance and the Federal Reserve's discount window—to apply only to traditional commercial banks and not to the nonbank affiliates of bank holding companies or the parent companies themselves (for which the safety net was never intended).

Second, customers, creditors and counterparties of all nonbank affiliates and the parent holding companies would sign a simple, legally binding, unambiguous disclosure acknowledging and accepting that there is no government guarantee—ever—backstopping their investment. A similar disclaimer would apply to banks' deposits outside the Federal Deposit Insurance Corp. (FDIC) protection limit and other unsecured debts.

Third, we recommend that the largest financial holding companies be restructured so that every one of their corporate entities is subject to a speedy bankruptcy process, and in the case of the banking entities themselves, that they be of a size that is "too small to save." Addressing institutional size is vital to maintaining a credible threat of failure, thereby providing a convincing case that policy has truly changed. This step gets both bank incentives and structure right, neither of which is accomplished by Dodd–Frank.

The downsized, formerly too-big-to-fail banks would then be just like the other 99.8 percent, failing with finality when necessary—closed on Friday and reopened on Monday under new ownership and management in the customary process administered by the FDIC.

The aim of our three-step proposal is simple: All banks would be subject to the same regulatory oversight—and most important, they all would be subject to the market discipline exercised by owners and creditors.

Had this plan been in place a decade ago, it would have altered the insidious behaviors that contributed to the crisis, avoiding the bailouts and their aftermath, the cost of which our nation's citizens will bear for years to come. The GAO and others estimate that the cost of the financial crisis, measured in lost production and jobs, could exceed roughly one whole year of U.S. output.[8]

Most of all, adoption of a proposal such as ours would have avoided a crisis that undermined Americans' belief in the fairness and justice of the economic system. The United States was founded on the principle of economic freedom, underpinned by secure property rights and by a strong aversion to special favors and subsidies to the few. Those fundamental virtues were undermined by the recent financial crisis and government's response to it.

Rescuing too-big-to-fail banks from their bad investment decisions imposed an enormous economic burden on the American people. It also perpetuated a sense that powerful banking mandarins operate above the law and prosper at the expense of the thrifty and hardworking citizenry.

Without delay, Congress should rewrite Dodd–Frank so that it actually ends the problem of banks that are too big to fail. Our proposal provides a road map for doing so. It will not lead to bigger government. It will, instead, lead to less but more effective regulation, banks that are governed by the market discipline of creditors who are at real risk of loss, and laws that apply equally to all.

In my introduction, I referred to Patrick Henry. In the speech I quoted, he went on to say, "It is natural to man to indulge in the illusions of hope. We are apt to shut our eyes against a painful truth, and listen to the song of that siren till she transforms us." I implore you to be practical and not succumb merely to the illusion of hope. Don't listen to the siren song of the megabanks and their lobbyists. Take action to deal with the unfair advantages that these institutions enjoy. They will spend millions of dollars to try to perpetuate their brand of crony capitalism. Resisting their entreaties is the right thing to do. Leveling the playing field is a just cause for all Americans. It demands redress from those who represent us in the halls of Congress, whatever side of the aisle they sit on.

Next week, the Dallas Fed will release an additional essay on this very subject, together with responses to the questions and criticisms we have received about our proposal, including those raised by proponents for the megabanks. I ask you to go on the net and read that report.[9] But for now, I simply thank you for having me here today, and I wish you Godspeed.

Notes

[1] See "Ending 'Too Big to Fail'," speech by Jerome H. Powell, Federal Reserve Board of Governors, Institute of International Bankers 2013 Washington Conference, Washington, D.C., March 4, 2013, www.federalreserve.gov/newsevents/speech/powell20130304a.htm; "Financial Stability Regulation," speech by Daniel K. Tarullo, Federal Reserve Board of Governors, at the Distinguished Jurist Lecture, University of Pennsylvania Law School, Philadelphia, Oct. 10, 2012, www.federalreserve.gov/newsevents/speech/tarullo20121010a.htm; and "Fostering Financial Stability," speech by Chairman Ben S. Bernanke, Federal Reserve Board of Governors, at the 2012 Federal Reserve Bank of Atlanta Financial Markets Conference, Stone Mountain, Ga., April 9, 2012, www.federalreserve.gov/newsevents/speech/bernanke20120409a.htm.

[2] For a recap of comments made during the Q&A period following Attorney General Eric Holder's Senate testimony, see "Holder: Banks May Be Too Large to Prosecute," *Wall Street Journal*, March 6, 2013, http://blogs.wsj.com/washwire/2013/03/06/holder-banks-may-be-too-large-to-prosecute.

[3] For one example of the TBTF advantage observed in the spreads paid for longer-term debt, see "BIS Annual Report 2011/12," Bank for International Settlements, June 24, 2012, pp. 75–6, www.bis.org/publ/arpdf/ar2012e.htm.

[4] See "Why Should Taxpayers Give Big Banks $83 Billion a Year?" Bloomberg, Feb. 20, 2013, www.bloomberg.com/news/2013-02-20/why-should-taxpayers-give-big-banks-83-billion-a-year-.html.

[5] See "On Being the Right Size," speech by Andrew Haldane, Bank of England, at the 2012 Beesley Lectures, Institute of Economic Affairs' 22nd Annual Series, London, Oct. 25, 2012, www.bankofengland.co.uk/publications/Documents/speeches/2012/speech615.pdf.

[6] See "Big Banks Have a Big Problem," by Simon Johnson, *New York Times*, March 14, 2013, http://economix.blogs.nytimes.com/2013/03/14/big-banks-have-a-big-problem.

[7] See "Dodd–Frank Burden Tracker," U.S. House Financial Services Committee, http://financialservices.house.gov/burdentracker.

[8] See "Financial Crisis Losses and Potential Impacts of the Dodd–Frank Act," Government Accountability Office, GAO-13-180, Jan. 16, 2013, www.gao.gov/products/GAO-13-180.

[9] See "Vanquishing Too Big to Fail," by Richard W. Fisher and Harvey Rosenblum, Federal Reserve Bank of Dallas 2012 Annual Report, March 2013 (forthcoming).