Choosing the Road to Prosperity: Why We Must End Too Big to Fail – Now

Presentation adapted from the Dallas Fed 2011 Annual Report

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The views expressed are those of the speaker and should not necessarily be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.
Dallas Fed 2011 Annual Report Media Response

Press Coverage:
- Forbes
- Rolling Stone
- PBS Frontline
- CNBC
- The NY Times
- Wall St. Journal
- American Banker

Predominantly positive feedback
But we left some of the important “next steps” and “how to” out
Economic stagnation

The wrong path:
Keep TBTF Status quo

The preferred route:

“When you come to a fork in the road, take it...”
What’s the Status Quo?

- A wimpy recovery
- After avoiding a possible depression
- And we’ve yet to fully address the financial system dysfunction
It’s in our DNA:

- Complacency
- Complicity
- Exuberance
- Greed

Conclusion:
These human traits and weaknesses result in market disruptions that are generally occasional and manageable.

More severe crises occur if implicit government support undermines market discipline.
Time Spent in Recession Declined

Percentage of time spent in recession

<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1857–1915</td>
<td>47</td>
</tr>
<tr>
<td>1916–1938</td>
<td>39</td>
</tr>
<tr>
<td>1939–1960</td>
<td>16</td>
</tr>
<tr>
<td>1961–1982</td>
<td>17</td>
</tr>
<tr>
<td>1983–2007</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: National Bureau of Economic Research
Willful Blindness

Practice of willful blindness:
the human tendency to see what we want to see
or are conditioned by our life experience to see

All Players
- Banks / Lenders
- Rating agencies
- Regulators
- Bank creditors
- Borrowers
- Prominent economists
Governor Sue Bies
FOMC May 10, 2006 Public Transcript p.64–65

- Governor Bies pointed out that the growing ingenuity in the mortgage sector was a cause for concern
- In hindsight, her comments were regretfully not heeded
All Booms End Up Busts

**Boom**
- Easy money
- Speculation
- New, risky instruments
- Run-up in asset prices
- Borrow and consume

**Buying into the exuberance**

But then comes a sad refrain of regret: How could we have been so foolish?

**History is easy to forget**
- 1637 Dutch tulip mania
- 1720 South Sea bubble
- 1989 Japanese RE & Equity
- Late ’90s Beanie Baby bubble
- 2000 Dot-com bubble

Recent memory
U.S. Banking Industry Concentration

1970

- 12,500 smaller banks (46%)
- 5,700 smaller banks (37%)
- 17 Top 5

2010

- 5,700 smaller banks (32%)
- 5,700 smaller banks (52%)
- 16 Top 5

Concentration Kills

- Concentration intensifies the impact of mistakes

“Human weakness will cause occasional market disruptions. Big banks backed by government turn these manageable episodes into catastrophes.”

“Then he dropped his bombshell ...
Here’s the drill. We need to prepare **right now** for **Lehman Brothers** filing... and for **Merrill Lynch** filing... and for **AIG** filing. **Another pause.**
And for **Morgan Stanley** filing.
*After an even longer pause*, he added:
and potentially for **Goldman Sachs** filing...
*There was a collective gasp on the phone.*”
We Were at the Edge of the Cliff

Additional points:
- Verified the accuracy of this quote with Jamie Dimon
- Dimon did not even mention the need to prepare for filings by BAC, C or WFC. They were TBTF.
- Neither Jamie Dimon, Hank Paulson, Ben Bernanke, nor Tim Geithner were trained to make fate-of-the-world decisions.
  "They don’t teach you that at MIT…"
  – Roger Lowenstein  

- Could the bankruptcy courts have handled *SIMULTANEOUS* filing of five of the largest Chapter 11 bankruptcies in history??
The Banking Bust 2008–2009

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total $$ of 165 failed institutions:</td>
<td>$542 billion</td>
</tr>
<tr>
<td><strong>Total Assets of (essentially 2) Assisted Banks:</strong></td>
<td>$3.22 trillion</td>
</tr>
<tr>
<td>(failure with a different label)</td>
<td></td>
</tr>
<tr>
<td><strong>Bank assets directly supported ‘08–’09:</strong></td>
<td>$3.8 trillion</td>
</tr>
<tr>
<td>+ Commercial Bank assets of 7 other firms forced to take TARP funds:</td>
<td>$4.0 trillion</td>
</tr>
<tr>
<td><strong>Total Banking Assets Supported:</strong></td>
<td>$7.8 trillion</td>
</tr>
<tr>
<td>~2/3 of the commercial banking industry!</td>
<td></td>
</tr>
</tbody>
</table>
o And oh, by the way, their liabilities are *our money*, what we use to pay for the things we buy

o Good reason to have a separate failure resolution regime for banks
**Too Big to Fail**

**TBTF** /tee-bee-tee-ef/
The unwillingness of a government entity to abruptly close an insolvent company and force its creditors to sustain sizeable losses due to the company’s size, complexity, interconnectedness and general significance within the financial system.

*Related:* If taxpayer funds are used to prolong the life of the company, it is generally labeled a *bailout.*

*Reference:* zombie, living dead and walking dead.

*See also:* systemically important financial institution (SIFI)
Too Big to *Fail* is a Misnomer

**Degrees of Failure:**
- Bankruptcy
- Buyout
- Bailout

Different labels, but all very similar: part of the process of *creative destruction*

*But with several important differences—especially PRIVATE v. TAXPAYER FUNDING*
The Federal Reserve’s Policy Responses
Policy-Making Is Complicated

Actions → Consequences

- Benefits
- Costs

Intended → Good
Unintended → Bad

Need for additional actions to offset the bad unintended consequences.
Extraordinary Times…

...call for extraordinary policies:

✓ Special credit and liquidity facilities
✓ Extended safety net beyond commercial banking
✓ ZIRP(s)
✓ QE(s)
✓ Operation Twist
Monetary Policy Responses

‘07–’08

Special facilities*
- Term Auction
- Term Securities Lending
- Primary Dealer Credit
- Money Market Investor Funding
- Commercial Paper Funding
- ABCP MMMF Liquidity

* + Bear Stearns, AIG special credit facilities; under Section 13(3) “urgent and exigent circumstances”

Late ’08

ZIRP 1

Spring ’09

QE 1

Fall ’10

QE 2

Fall ’11

ZIRP 2 + MEP

Early ’12

ZIRP 3

- Purchase $600 billion more longer-term Treasuries by Q3 ’11
- Purchase up to $1.25 trillion in agency MBS, $200 billion in agency debt and $300 billion in longer-term Treasuries
- “exceptionally low levels… at least through late 2014”
  + projections
  + goals & policy communication

Key:
ZIRP: zero interest rate policy
QE: quantitative easing
MEP: maturity extension program
### Financial & Economic Events

<table>
<thead>
<tr>
<th>Year</th>
<th>Event 1</th>
<th>Event 2</th>
<th>Event 3</th>
<th>Event 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>’07–’08</td>
<td>Nonbank SIFIs get in trouble</td>
<td>Big banks suffer significant losses</td>
<td>Economy in trouble</td>
<td>Small and medium banks struggle</td>
</tr>
<tr>
<td>’08–’09</td>
<td>'07–’08 '08–’09 '09–’10 '10–’12</td>
<td>'07–’08 '08–’09 '09–’10 '10–’12</td>
<td>'07–’08 '08–’09 '09–’10 '10–’12</td>
<td>'07–’08 '08–’09 '09–’10 '10–’12</td>
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<td>’09–’10</td>
<td>Economy in trouble</td>
<td>Small and medium banks struggle</td>
<td>Sluggish recovery</td>
<td></td>
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<tr>
<td>’10–’12</td>
<td>Sluggish recovery</td>
<td></td>
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### Monetary Policy Responses

<table>
<thead>
<tr>
<th>Year</th>
<th>Policy 1</th>
<th>Policy 2</th>
<th>Policy 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>’07–’08</td>
<td>Special facilities</td>
<td>ZIRP 1</td>
<td>QE 1</td>
</tr>
<tr>
<td>’08–’09</td>
<td>ZIRP 1</td>
<td>QE 1</td>
<td>QE 2</td>
</tr>
<tr>
<td>’09–’10</td>
<td>QE 2</td>
<td>QE 2</td>
<td>ZIRP 3</td>
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<td>’10–’12</td>
<td>ZIRP 3</td>
<td>ZIRP 3</td>
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“If your only tool is a hammer, every problem looks like a nail”
Fed’s Monetary Policy Toolbox

The Fed actually has 2 instruments:
1. **THE HAMMER — FED FUNDS RATE**
2. **A SCREWDRIVER — LENDING FUNCTION**

Both provide **LIQUIDITY**
- Fed’s lending function is designed to be a standing facility generating support for banking system commitments

But they do not address **SOLVENCY**, and they won’t in the next crisis either

Need appropriate **fiscal policy** and **regulation** to address solvency issues.
Why so much monetary policy firepower to deal with the crisis?

Central Bank Balance Sheet Expansion since July 2007

- **Fed**: 3.3X
- **ECB**: 2.2X
- **BoE**: 4.2X
The Blob That Ate Monetary Policy

Banks that are 'too big to fail' have prevented low interest rates from doing their job.

By RICHARD W. FISHER AND HARVEY ROSENBLUM

Monetary policy is undermined by TBTF banks

Monetary policy is undermined by TBTF banks

Fans of campy science fiction films know all too well that outsized monsters can wreak havoc on an otherwise peaceful and orderly society.

But what B-movie writer could have conjured up this scary scenario—Too Big To Fail (TBTF) banks as the Blob that ate monetary policy and crippled the global economy? That's just about what we've seen in the financial crisis that began in 2007.

While the list of competitive advantages TBTF institutions have over their smaller rivals is long, it is also well-known. We focus instead on an unrecognized macroeconomic threat: The very existence of these banks has blocked, or seriously undermined, the mechanisms through which monetary policy influences the economy.
Monetary Policy Engine Is Not Hitting on All Cylinders

- Undercapitalized banks gum up the working of the interdependent moving parts of the monetary policy engine
- Sick (or failed) banks can’t lend
What’s Being Done?

Dodd-Frank Act (DFA)
Primary goal: *End TBTF*

Means / efforts to that end:
- Raise capital
- Increase liquidity
- Implement an *orderly liquidation authority* for SIFIs

Procedure:
- Will likely work for closing a single large financial firm
- Relies on FDIC
  - Good at closing small banks
  - However, limited experience with large banks or SIFIs
Options to End TBTF

In order to keep the TBTF behemoths from crushing the financial system again in the future

Some possibilities

- Follow DFA as enacted
  - Negatively impacts community banks (*unintended consequence*)

- Encourage restructuring and streamlining

**Goal:** choose the *LEAST BAD* solution

*There are no “good” solutions*
Restructuring Less Radical Than Most Alternatives

The “WHAT” is determined:
- Congress and Justice Department design the general rules / guidelines

The “HOW” is left to others:
- Banks choose how to streamline and refocus
- Private-sector buyers help rationalize the business model
- CREATIVE DESTRUCTION allowed to work

Otherwise, consider the alternatives:
- Quasi-nationalization as in 2008–2009
- Full nationalization, a Great Depression-type scenario
Goal: Separation of Bank and State
# Ending Too Big to Fail

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>❖ Enhanced market discipline</td>
<td>❖ May forego some benefits of economies of scale and scope</td>
</tr>
<tr>
<td>❖ Costs of failure are private costs, and not socialized</td>
<td>❖ One-stop shopping for financial services becomes more difficult, perhaps weakening “customer experience”</td>
</tr>
<tr>
<td>❖ Reduced monopoly power</td>
<td></td>
</tr>
<tr>
<td>❖ Level playing field</td>
<td></td>
</tr>
<tr>
<td>❖ Safer, more resilient financial and economic system</td>
<td></td>
</tr>
<tr>
<td>❖ Restore faith in market capitalism</td>
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</tr>
</tbody>
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**On net, benefits of ending TBTF far outweigh the costs**
Overview: A Few Guiding Principles for Financial System Reform

To achieve a more competitive & resilient financial system:

- **Harness market forces and incentives as much as possible**
  – Limit the federal safety net to depository institutions – and NOT their affiliated companies, creditors or counterparties.

- **End banking oligopoly power**
  – Reduce industry concentration and TBTF subsidies.

- **Punish failure quickly**
  – Specify, in advance, harsh, non-negotiable consequences for requesting or requiring taxpayer assistance

- **Change the “do-or-die” decisionmaking paradigm**
  – Reduce the likelihood of politics driving taxpayer assistance
A Few Guiding Principles for Financial System Reform

Harness market forces and incentives as much as possible

- Limit the federal safety net to federally insured deposits and a fully collateralized lender-of-last-resort facility available only to legally separable depository institutions – and NOT their affiliated companies.

- All creditors and counterparties of financial companies / entities other than federally insured depository institutions put on notice that there is no federal safety net covering their transactions. NONE.
End banking oligopoly power

- *Quasi-nationalized* companies receiving taxpayer assistance are by definition getting federal subsidies and are provided an unfair advantage over other “nonsubsidized” competitors.

- A level playing field requires that assisted companies be *wound down* and *closed quickly*. In addition, the largest financial institutions should be *last in line* to acquire the assets of failed institutions; *reduce*, not increase, *industry concentration*.

- While there may be significant economies of scale / scope, they need to be weighed against *economies of specialized expertise* and *diseconomies of dysfunctionality, monopoly power, TBTF subsidies* and *devolution of cross-border banking institutions*. 
Punish failure quickly

- Specify, in advance, a set of harsh, non-negotiable consequences for requesting or requiring U.S. Treasury (taxpayer) assistance (or capital injections of any kind).

Such as:

- Removal of CEO and top executive team, replacement of Board of Directors, and making all employment / compensation and bonus contracts null and void as a precondition for taxpayer assistance. No golden parachutes.

- Clawback of any bonus compensation (cash and stock) paid to the top management team in the two years prior to receiving federal assistance.
A Few Guiding Principles for Financial System Reform

Change the “do-or-die” decisionmaking paradigm

- Steer the evolution of the financial structure so that the Treasury Secretary is unlikely to be faced with an edge-of-the-cliff decision to provide taxpayer assistance or be held responsible for a great depression.
  
  – Neither the Treasury Secretary nor Federal Reserve Chairman is trained or equipped for making “fate-of-the-world” decisions. *Nobody is, really.*

- Actively guard against *willful blindness.*
Reinforce the Market

- These recommendations are not actually that radical!
- The market is already moving this direction
  – Rewarding reduced complexity

Average price-to-book value ratio

<table>
<thead>
<tr>
<th></th>
<th>Super big &amp; complex</th>
<th>Very big, not as complex</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average price</td>
<td>0.0</td>
<td>1.0</td>
</tr>
<tr>
<td>0.5</td>
<td>0.5</td>
<td>1.5</td>
</tr>
<tr>
<td>1.0</td>
<td>1.0</td>
<td>1.5</td>
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<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Wells Fargo, U.S. Bancorp, M&T, BB&T, Fifth Third

JP Morgan, Goldman, Citigroup, Morgan Stanley, B of A

SOURCE: “Bank Investors Bail on Too-Big-to-Fail,” by David Reilly, WSJ, 5/16/12
Too Complex to Manage and Supervise
Extreme Complexity: Citi

- 84 countries
- 2,435 subsidiaries
- 101 bank subs
- 706 mutual funds and SPVs
- 584 other financial subs
- 1,009 nonfinancial subs
Organizational Complexity | Avg. | Min | Max | Avg. (without Citi)
--- | --- | --- | --- | ---
# of countries | 44 | 16 (RBS) | 84 (Citi) | 41
# of subsidiaries | 1,005 | 267 (Merrill Lynch) | 2,435 (Citi) | 903
# of insurance subsidiaries | 20 | 2 (UBS) | 74 (BNP Paribus) | 19
# of mutual funds and SPVs | 227 | 48 (Goldman) | 706 (Citi) | 193
# of nonfinancial subsidiaries | 440 | 68 (Merrill Lynch) | 1,009 (Citi) | 399

Status quo:
We’re on the road to economic stagnation
Suffering and perpetuating perverse incentives

Where we want to go:
Get to the road to prosperity and get back to basics
Restructuring isn’t so radical, firms do it all the time
In Conclusion

END TBTF ASAP

NOW!
Recent Media Focus
Impact of 2011 Dallas Fed Annual Report

Choosing the Road to Prosperity: Why We Must End Too Big to Fail – Now

Complete Annual Report issue and presentation may be found at:
http://www.dallasmfed.org/fed/annual/index.cfm
The Public Debate Surrounding TBTF

How Huge Banks Threaten the Economy

By RICHARD W. FISHER AND HARVEY ROSENBLUM

Our nation is at a fork in the road and the destiny of our financial system depends critically on choosing the correct route. One path leads to a continuation of the status quo, where some financial institutions are ordained by government policy to be "too big to fail" (TBTF) and where the rules of market capitalism are undermined and subverted. The other—the path to long-term prosperity—is the one we’ll be on when we truly end TBTF.

- Kicked off public debate about the danger of TBTF banks
- Filled in some important “next steps” and “how to” from the Annual Report Essay
- Market-focused break-up far less radical than quasi-nationalization (as in, 2008-2009)
Warren Stephens: How Big Banks Threaten Our Economy

We should promote competition and innovation in the financial industry, not protect an oligopoly.

By WARREN A. STEPHENS

As of this past January, any bank operating in the United States with more than $50 billion in assets must have the business equivalent of a living will—plans for what to do in the event of catastrophe. Every well-managed business should have contingencies and ways to assess its health and viability. But the fact that the Dodd-Frank financial regulations require the largest banks to submit detailed plans for worst-case scenarios suggests something is seriously amiss.

Too Big to Insure: banks so large that the FDIC and other agencies could not deal with them

Size and scale: they are the problem, not the advantages they were thought to be
The Public Debate Surrounding TBTF

Fisher again reiterates: “If you’re ‘too big to fail’, you’re too big”
The Public Debate Surrounding TBTF

Separate the lending culture from the culture of investment, hedging and speculative services

The implicit understanding that taxpayers will support the broker-dealer operations is a perversion of capitalism

By TOM C. FROST

In the early 1950s, when I was a young college graduate and a new employee of the Frost Bank, my great-Uncle Joe Frost, then CEO, told me that the very first goal we had was to return the deposits we received from customers. Our obligation was to take care of the community's liquid assets and manage them safely so others could use them (via loans) to grow.

Frost Bank was not big enough to be saved by the government, Uncle Joe told me at the time, so we would always need to maintain strong liquidity, safe assets and adequate capital. I was impressed that making money was not high on his list of priorities, but he implied that profits would come if we observed sound banking principles.
Market already providing incentives to downsize, simplify and restructure; rewarding reduced complexity.
GE Capital Chairman Mike Neal addressed questions about the possibility of selling the private-label credit-card business...
"Is it severable? Sure. Everything is."
The Public Debate Surrounding TBTF

- “Regulation is not the solution...a well-run financial system cannot be micromanaged through elaborate regulatory codes.”

- Giant diversified financial institutions are **Too Conflicted to Manage**
“In the end, nobody—not managements, the market or regulators—could adequately assess and control the risks of these firms.”

“Glass-Steagall” for today: “strengthen the U.S. financial system by simplifying its structure and making its institutions more accountable for their mistakes”