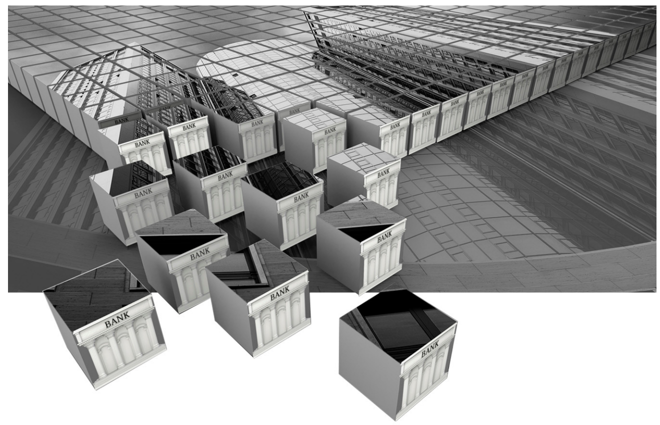
DALLASFED
2012 Annual Report

Vanquishing Too Big to Fail

By Richard W. Fisher and Harvey Rosenblum

The solution for ending “too big to fail” is not bigger government but smaller, unsubsidized banking institutions governed by the market discipline of creditors at risk of loss.



The United States is burdened by a highly concentrated financial system where the dozen largest banking institutions control almost 70 percent of banking industry assets. This excessive concentration intensified during the 2007–09 financial crisis when several, presumably healthy big banks absorbed some of their failing rivals. Another round of consolidation will likely accompany the next crisis, further reducing competition.

Public policy subsidizes excessive risk taking among the largest financial institutions, whose managements know their banks won’t be allowed to fail if their bets go bad. The banks’ creditors similarly believe the government will backstop their investments, simultaneously undermining the profitability and viability of smaller institutions that enjoy no such implicit guarantee. Economics 101 tells us that if you want more of something, you should subsidize it. The irony is that government policy subsidizes excessive risk taking, the very thing we want to reduce. Increased industry concentration induced by a policy of too-big-to-fail (TBTF) institutions, raises the likelihood and potential damage of another financial meltdown.

Three Steps to Financial Reform

To address this situation, we have proposed confining access to the federal safety net—the Federal Reserve’s discount window and federal deposit insurance protection—to traditional commercial banks. Further, we advocate that customers and creditors of companies affiliated with commercial banks sign a disclaimer acknowledging their understanding that there is no federal guarantee underpinning their relationship with these nonbank units or with the parent of any banking company. We believe these two steps would reduce the perverse incentives stemming from the implicit—but widely recognized—creditor protection offered to TBTF institutions. These two changes would help realign incentives to better resemble those faced by customers of smaller banks whose unsecured creditors and equity shareholders are exposed to losses. In short, our proposal would revive the inhibited forces of market discipline.

Unfortunately, established customer relationships are slow to change. To accelerate the transition to a more competitive financial system, our proposal has a third element to help level the playing field. Specifically, we recommend that the largest financial institutions be restructured so that every one of their corporate entities is subject to a speedy bankruptcy process, and in the case of banking entities, that each be of a size that is “too small to save.” This last step gets both the incentives and the structure right, neither of which is accomplished by relying on the Dodd–Frank Wall Street Reform and Consumer Protection Act. The aim of our three-step proposal is to underscore to customers and creditors that a credible regime shift has taken place, and the reign of TBTF policies is over.

Answers to Some Serious Questions

To further clarify our position and address the many questions, comments and suggestions we have received, we offer some additional amplification. Regarding who should drive the financial reform process, we believe that the mandate, guiding principles and deadlines for downsizing are legislative matters for the Congress to determine. However, the design and details of each company’s restructuring should be left to the management and board of directors representing the owner-shareholders. Strong management involvement is necessary to ensure that all spun-off banks and other subsidiaries are viable and profitable companies, able to attract and retain financial capital and management talent. Such restructuring of TBTF financial institutions should be accomplished with minimal statutory modifications and limited government intervention.

(Continued from Vanquishing Too Big to Fail)

Although TBTF financial institutions were not the sole cause of the financial crisis, they were a primary mechanism through which shocks were transmitted throughout the financial and economic systems. Many TBTF banks and their subsidiaries were major players in shadow banking activities dependent on short-term, nondeposit wholesale funding—using financial instruments such as commercial paper and money market funds—that spread systemic risk pervasively at the height of the crisis. Moreover, TBTF status grants these giant institutions a continuing subsidy that facilitates their further growth and ever-greater risk taking, inducing yet more financial system instability.

Some commentators believe that our plan to downsize the largest banks would shrink the financial sector and its overall employment. We believe, however, that our proposal would increase the number of banks, bolstering competition and providing additional services that benefit bank customers. In addition, affiliate companies' ancillary financial services would not disappear; to accommodate market demand, these services will continue, but without subsidies and with a noticeably greater level of due diligence from creditors. Again, increased market discipline, the toughest regulator of all, would mediate credit behavior and improve transparency around riskier activities.

One line of argument suggests the financial system and its health are in stable equilibrium, and Dodd–Frank needs to be given time to prove it will work as intended. We contend that reliance on Dodd–Frank to end TBTF is simply the triumph of hope over experience. We've been down this road before, where bailouts and increased concentration become the only feasible alternatives in a crisis. Our proposal would alter the structure of banking so that bailouts become unnecessary. Under our proposed policy change, the largest banking institutions would pose far less systemic risk.

Additionally, to those who say "just give Dodd–Frank a chance," we note that partial repeal of Dodd–Frank has already occurred through the back door. Megabanks, in the U.S. and abroad, have pushed back to significantly weaken capital and liquidity standards, the statute's purported structural pillars. Moreover, the penance and legal penalties paid to date for egregious errors in mortgage finance, manipulation of the London interbank offered rate (LIBOR) and other legally and ethically questionable activities have been almost immaterial to the large banks (or at least appear insufficient to deter such practices). Under Dodd–Frank, taxpayers remain exposed to similar, possibly larger, losses among giant financial institutions during the next crisis.

Some critics worry that our plan will drive large banks to move their risky activities to other countries that wish to be a haven for giant universal banking institutions. Such havens are already available, but the grass over there may not be greener. Many of these countries have been nearly bankrupted by the failure of their own giant banks, some of which have assets greater than their nations' GDPs. Their taxpayers do not necessarily welcome the prospect of propping up more TBTF banks. And having a large number of very big institutions is no guarantee of economic success in a competitive global economy. Japan had more than half of the world's largest 25 banks in the 1990s (*Table 1*), and for two decades, it has been the caboose of the global economic freight train.

No Reform Plan Is Perfect

We concede our proposal doesn't have all the answers. It would not eliminate financial crises, but it should reduce their frequency and severity. Nor will it alter the human DNA of those who serve as "first responders" during the next crisis. Our proposal should make the magnitude of the problems regulators face, and the tasks they need to perform, far more manageable. Under our plan, supervisory agencies would confront several thousand community banks, a few hundred moderate-size banks (by today's standards) and **no** megabanks. The nonbank and shadow bank companies would operate without a subsidized safety net and with long-overdue market discipline imposed by at-risk creditors.

There will always be some banks that are larger than the rest, and consequently, there will be temptation for regulators to label the "biggest few" as systemically important. The fluctuating nature of human resolve and political fortitude, as well as the problem of "regulatory capture," has been present in U.S. bank policy at least since the intervention/bailout of Continental Illinois and its creditors in 1984. Our proposal cannot and will not prohibit regulators from intervening to support the unsecured creditors of a failing banking institution. But our proposal reduces the dimensions of the problem—asset size and systemic interconnectedness—by an order of magnitude and thereby should diminish the tendency to intervene out of fear of unknown systemic risks. Our plan would dramatically reduce the costs of non-intervention.

(Continued from Vanquishing Too Big to Fail)

A metaphor helps illustrate the point. Question: How do you eat breakfast cereal? Answer: One spoonful at a time. Question: How do you deal with a banking crisis? Answer: One bank failure at a time. The status quo under Dodd–Frank could translate into the complications of rescuing, supporting and resolving various parts of giant financial institutions using taxpayer funds for several years. Under our proposal, historical experience suggests, one bank failure at a time is a manageable proposition because all banks will have been made too small to save. None would be too big to fail. The FDIC would be "in on Friday and out on Monday," maybe a few days later, perhaps a little longer in the case of bigger and more complex banks. To complete the breakfast cereal metaphor, under our proposal, bank supervisors would deal with the task of eating a cup of cereal, one spoonful at a time. Under the Dodd–Frank status quo, bank supervisors would eventually confront resolving a behemoth bank, a job tantamount to eating a bushel of cereal. This would be an insurmountable task for regulators whose training and natural impulse would irresistibly tempt them into a bailout. Awareness of this pattern of using bailout as the default response reinforces creditors' tendency to exert no market discipline forever and always. Stated differently, under Dodd–Frank, supervisory action would continue to "put it to the taxpayers."

Ultimately, Taxpayers Foot the Bill for Subsidies

Our proposal for financial reform also addresses the growing inability of our financial system's insurer of last resort—the U.S. taxpayer—to backstop the financial system in future financial crises. In 1990, the four largest banking institutions had assets of $519 billion, about 9 percent of U.S. gross domestic product (GDP). By 2011, the four largest banking organizations held assets exceeding $7.5 trillion, amounting to 50 percent of GDP (*Chart 1*).

This is just their on-balance-sheet assets; if U.S. bank balance sheets were adjusted to international standards (instead of U.S. Generally Accepted Accounting Principles), their asset sizes would reflect significantly more exposure to derivatives and mortgages currently excluded from U.S. regulatory filings. The biggest banks are even bigger than meets the eye. Part of their growth, both absolutely and relative to GDP, has been driven by the subsidized nature of TBTF banking.

Remember the corollary of the Economics 101 lesson: Subsidized activities will grow faster than unsubsidized activities. Taxpayers didn't approve their exposure to losses in the recent financial crisis or potentially in the next one. Massive taxpayer exposure resulted from the happenstance of TBTF banks responding to the perverse incentives of subsidies implicitly granted to the banking industry's giants. Such taxpayer exposure is not something that should become embedded into the fabric of our financial system.

We have addressed a few of the most common questions and suggestions. Our response to other points of contention can be found in the accompanying interview with Richard Fisher.

Protect Taxpayers, Not Megabanks

The potential taxpayer burden of dealing with TBTF institutions could be addressed by a still-growing army of bank supervisory personnel trying to enforce the rigid, complex and probably easy-to-evade rules of Dodd–Frank. It would be oversight without the benefit of supplemental reinforcement from market discipline and increased due diligence.

Under our plan, the solution for ending TBTF is not bigger government, but smaller, unsubsidized banking institutions governed by the market discipline of creditors at risk of loss.

The views expressed are those of the Federal Reserve Bank of Dallas and not necessarily those of others in the Federal Reserve System. We thank David Luttrell for his excellent assistance throughout this project.

About the Authors

Richard Fisher is president and chief executive officer and Harvey Rosenblum is executive vice president and director of research at the Federal Reserve Bank of Dallas.

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Table 1
World's Largest 25 Banks: Then and Now

1990				2011			
Rank	Banking organization	Country	Assets (billions of U.S. dollars)	Rank	Banking organization	Country	Assets (billions of U.S. dollars)
1	Dai-Ichi Kangyo Bank Ltd.	Japan	428	1	Deutsche Bank	Germany	2,800
2	Sumitomo Bank Ltd.	Japan	409	2	HSBC	United Kingdom	2,556
3	Mitsui Taiyo Kobe Bank Ltd.	Japan	409	3	BNP Paribas	France	2,543
4	Sanwa Bank Ltd.	Japan	403	4	Industrial and Commercial Bank of China	China	2,456
5	Fuji Bank Ltd.	Japan	400	5	Mitsubishi UFJ Financial Group	Japan	2,448
6	Mitsubishi Bank Ltd.	Japan	392	6	Credit Agricole	France	2,432
7	Credit Agricole Mutuel	France	305	7	Barclays Group	United Kingdom	2,417
8	Banque Nationale de Paris	France	292	8	Royal Bank of Scotland	United Kingdom	2,330
9	Industrial Bank of Japan Ltd.	Japan	290	9	**JPMorgan Chase**	United States	2,266
10	Credit Lyonnais	France	287	10	**Bank of America**	United States	2,129
11	Deutsche Bank	Germany	266	11	China Construction Bank (CCB)	China	1,949
12	Barclays PLC	United Kingdom	259	12	Mizuho Financial Group Inc.	Japan	1,890
13	Tokai Bank Ltd.	Japan	250	13	Bank of China	China	1,878
14	Norinchukin Bank	Japan	250	14	**Citigroup**	United States	1,874
15	Mitsubishi Trust & Banking Corp.	Japan	238	15	Agricultural Bank of China	China	1,853
16	National Westminster Bank PLC	United Kingdom	233	16	ING Group	Netherlands	1,655
17	ABN Amro Holding N.V.	Netherlands	231	17	Banco Santander	Spain	1,619
18	Bank of Tokyo Ltd.	Japan	223	18	Sumitomo Mitsui Financial Group	Japan	1,598
19	Societe Generale	France	220	19	Societe Generale	France	1,528
20	Sumitomo Trust & Banking Co. Ltd.	Japan	219	20	UBS	Switzerland	1,508
21	**Citicorp**	United States	215	21	Lloyds Banking Group	United Kingdom	1,501
22	Mitsui Trust & Banking Co. Ltd.	Japan	211	22	Groupe BPCE	France	1,473
23	Long-Term Credit Bank of Japan Ltd.	Japan	201	23	**Wells Fargo**	United States	1,314
24	Dresdner Bank	Germany	187	24	UniCredit	Italy	1,199
25	Compagnie Financiere de Paribas	France	186	25	Credit Suisse	Switzerland	1,115

NOTE: Data for banking organizations (holding company, when applicable) as of Dec. 31 (or March 31 fiscal year-end in the case of Japanese banks).

DATA SOURCES: "The Top 100 Banking Companies in the World," Ranking the Banks 1991, *American Banker*; "World's 50 Biggest Banks 2012," *Global Finance*.

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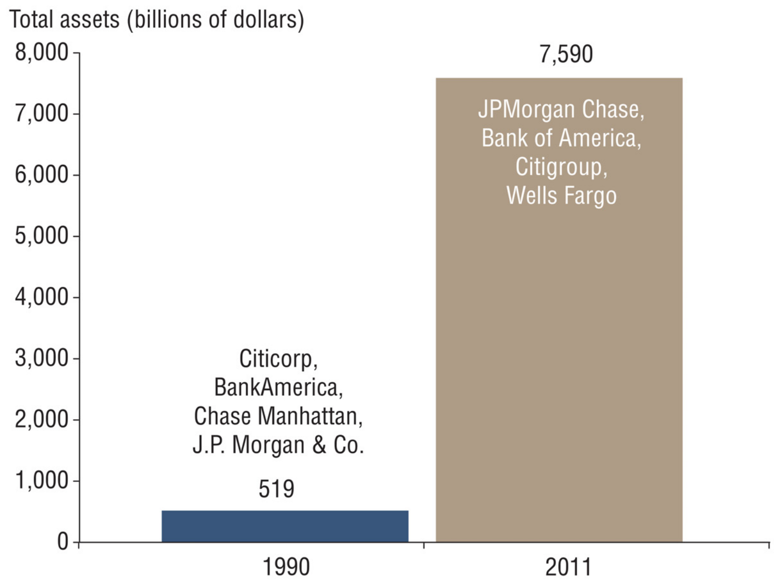
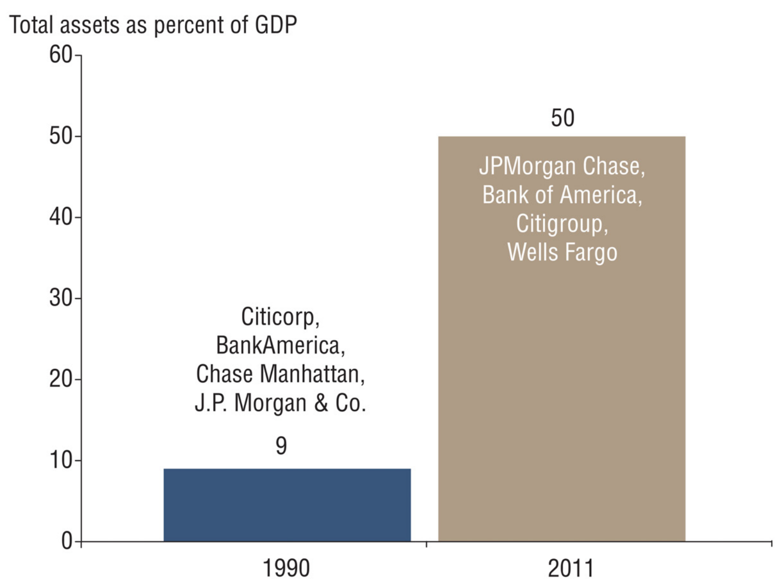
Chart 1
Explosive Growth of the Big Four Megabanks





NOTES: Asset size is based on the total assets of the U.S. banking organization (holding company, when applicable). Wells Fargo did not join the ranks of the Big Four until its 2008 acquisition of Wachovia.

DATA SOURCES: Call Report, Federal Financial Institutions Examination Council; Consolidated Financial Statements for Bank Holding Companies (FR Y-9C), National Information Center data, Federal Reserve System.