The Great Too-Big-to-Fail Debate

Stick with Dodd-Frank or break up the banks?

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You would never know it from the nasty presidential election year debate over too-big-to-fail, but nine years after the horrific financial crisis began in 2007, the U.S. financial system is in fine shape. Collectively, banks and savings institutions earned roughly $150 billion last year, only eight of 6,200 institutions failed, and most were small. Bank lending, hammered during the crisis, has largely recovered, albeit with more prudent underwriting standards. And banking regulation and supervision are far more stringent than they were a decade ago, particularly for the largest institutions. Nevertheless, memories of the crisis, the bailouts of institutions regarded as too big to fail, or TBTF, and the sense of unfairness those generated are playing a key role in the presidential nomination campaigns.

Senator Bernie Sanders of Vermont, seeking the Democratic nomination, insists in all his stump speeches that we must "break up the big banks" to ward off collapse of a TBTF institution that could trigger another crisis and perhaps another round of bailouts, and in the process bring Wall Street to heel. He brushes aside any thought that federal regulators implementing the Dodd-Frank Act have made enormous strides in reducing the risk of such a failure. Senator Ted Cruz of Texas, in his campaign for the Republican nomination, said all the big banks that got bailouts during the crisis should have been allowed to go broke, disregarding the devastating

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impact of a collapse of the financial system on the economy. Of course, he also touts the supposed virtues of a return to the gold standard.

In an interview with editors of the *New York Daily News,* Sanders would not say how large a bank would be okay or whether new legislation would be needed to force banks to shrink. He would let the banks themselves decide how to go about doing it.

Nowhere in the political wrangling is there any sense that breaking up the banks might create havoc in the country's financial system. For instance, a proposal by economist Simon Johnson of the Sloan School of Management at the Massachusetts Institute of Technology to limit bank assets to no more than 2 percent of U.S. GDP, or about $360 billion, would require the nation's three largest banks, JPMorgan Chase, Bank of America, and Citibank, to shed about one-third of the $16 trillion in all the nation's banks. That would require tens of millions of American households and businesses to find a different bank. Longstanding banking relationships would be obliterated. It would produce chaos and likely throw the economy into a tailspin. Is that sort of cost worth it to avoid the possibility of a TBTF failure? Banks and their financial intermediation services are a critical element in a healthy modern economy, which Sanders seems not to understand.

Meanwhile, Neel Kashkari, the new president of the Minneapolis Federal Reserve Bank, startled his Federal Reserve colleagues by making it plain that he, too, wants to break up the banks. Kashkari acknowledges the strides regulators have made in dealing with TBTF institutions, but said he doubts that officials would in fact be willing to take a chance that any large failure would not take the whole system down. At a seminar at the Brookings Institution earlier this year, Kashkari, a senior aide to Treasury Secretary Henry Paulson during the crisis, said his bank will host a series of symposiums this year to discuss the issue. And before the year is out, the Minneapolis Fed will formulate a plan for "transformational" policies that could eliminate all TBTF risk, Kashkari promised. Among the possibilities would be "breaking up large banks," he said.

Actually, most of the financial institutions that are regarded as TBTF are already shrinking as a result of major changes in banking regulations that have made it substantially more costly to be really big.

Dodd-Frank created the Financial Stability Oversight Council, or FSOC, comprised of representatives of ten major financial regulatory agencies, to deal with TBTF institutions. It is led by the secretary of the Treasury and it determines which institutions are TBTF. Officially, they are labeled global systemically important banking organizations, or GSIBs. A number of tough rules and costly regulations apply only to them.

Breaking up the banks might create havoc in the country's financial system.

As Federal Reserve Chair Janet L. Yellen explained in congressional testimony last fall, GSIBs are required "to hold larger amounts of loss-absorbing capital than other firms." The U.S. GSIBs "are central intermediaries in U.S. financial markets, and their failure or distress would thus likely cause the most harm to the financial system," she said. Therefore, they must hold more capital to reflect that risk.

"In effect,' Yellen said, "the risk-based capital surcharge confronts each U.S. GSIB with a choice: It can hold more capital, or it can reduce its systemic footprint."

Indeed, several have responded in just that way. For instance, Jamie Dimon, chairman of JPMorgan Chase, made a point of noting his bank's assets have shrunk by $220 billion, or almost 9 percent over the past two years. His bank is still the largest in the country, though, with assets of $2.35 trillion.

Assets at Citigroup, the third-largest U.S. GSIB, similarly declined by $149 billion, or 8 percent, over

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—*J. Berry*

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the two years to $1.73 trillion. In contrast, number two Bank of America's assets rose by nearly 4 percent, to $2.18 trillion.

There are even more significant changes among the four non-bank U.S. TBTF institutions—three insurance giants and GE Capital. The latter has formally petitioned the FSOC to remove its "systemically important" designation on the grounds that it has altered its business plan so that it will only finance industrial projects, and that it has already shrunk itself by 52 percent, with assets of $265 billion, down from $540 billion in 2012. It spun off its consumer finance business last year and has approval to sell its bank-like deposits to Goldman Sachs, another GSIB. This sort of development is exactly what Fed officials had hoped would happen.

Banking regulation and supervision are far more stringent than they were a decade ago.

The three insurance companies, MetLife, Prudential Financial, and American International Group, are also taking steps to downsize. At the same time, however, MetLife also filed and recently won a federal district court judgment that FSOC unfairly declared it to be TBTF. That has effectively removed the designation for now. The decision was a blow to FSOC's powers, and Treasury Secretary Jacob Lew said the government would appeal the decision. The judge's decision said that FSOC had failed to evaluate the likelihood that MetLife might someday find itself facing "material financial distress." If the decision is not overturned, that peculiar argument could undermine the foundation of Dodd-Frank. The point of the act is not to predict what institutions are likely to find themselves in trouble someday, but rather to make that unlikely because of a required high level of equity capital and effective supervision.

Finally, there are four large foreign banks that do enough business in the United States that Dodd-Frank requires that they group their U.S. business under separate holding companies and each is labeled as a GSIB. They are Barclays PLC in Britain, Deutsche Bank in Germany, and Credit Suisse Group and UBS in Switzerland. All of them, too, are reducing their size.

Credit Suisse's CEO, Tidjane Thiam, was hired last summer specifically to trim the global size of the bank, reduce costs, and make it less risky. He has announced plans to cut six thousand jobs, including two thousand in the trading portion of its investment bank. It has already shed hundreds of billions of dollars of its more risky assets such as collateralized loan obligations, Thiam said in late March. As he was moving last fall to advance this process, Thiam discovered that unbeknownst to top management, traders had taken "outsized" positions in some risky, illiquid instruments. "It's unfortunate," he said. "And I think it's also indicative of an attitude to risk that has to change."

None of this downsizing, of course, is necessarily in response to tighter regulation of its U.S. operations, but it is, like what has happened to GE Capital, exactly what Yellen and other Fed officials want to see, both in terms of an institution's size and its ability to know what risks are being taken and how well they are managed.

Capital surcharges on GSIBs are only one of the sweeping changes in bank regulations and supervision that have been put in place since Dodd-Frank was enacted in 2010. In general, the GSIBs have to hold much more capital with a larger share of it in the form of stockholder equity, which cannot disappear if a bank gets into trouble—as short-term financing did during the crisis. Since then, equity capital has more than doubled at the larger banks, boosting the total by nearly half a trillion dollars, Yellen said in last fall's testimony.

The GSIBs also shortly will have to comply with a 6 percent leverage ratio, double what it used to be. That is, the bank's equity capital must equal at least 6 percent of its debt.

In addition, all banks with $50 billion in assets, not just the GSIBs, are also now subject to annual reviews of whether they have enough capital to continue to do business in a time of stress, such as during a recession. If supervisors determine that they may not have enough capital for them to keep lending, then a bank may be required to stop paying dividends or take other actions, such as stock buybacks, that would distribute capital to shareholders. That has happened several times in recent years.

There are also new rules about liquidity. Prior to the crisis, many large firms, including Lehman Brothers, the investment bank whose bankruptcy triggered the acute stage of the crisis in September 2008, relied heavily on very short-term borrowing, often just overnight, to finance their assets. After the Lehman bankruptcy, that type of financing disappeared partly because investors had no good way of telling which institutions were still solvent.

Now GSIBs are subject to comprehensive reviews of their liquidity positions, including tests of what likely would happen to their funding if financial markets soured.

Again, the point is not just whether an institution might lose so much of its short-term financing that it might fail, but rather whether it could continue lending during a period of stress so that the public and the economy would not suffer a loss of credit availability.

These reviews take the form of annual stress tests. This year's test applied to the thirty-three U.S. banks with $50 billion or more in assets. The banks conducted the reviews themselves, and submitted the results to the Fed for evaluation in early April, using these three scenarios supplied by the Fed:

- Seriously Adverse: A severe global recession in which U.S. unemployment doubles from 5 percent to 10 percent, an extended period of corporate financial stress, and negative short-term Treasury securities interest rates.
- Adverse: A moderate recession with weakening economic activity across many countries and mild deflation in the United States.
- Baseline: Average projections from surveys for economic forecasters.

The stress tests were first used in 2009 for a very different purpose: to show to the public and to skeptical executives at many financial institutions that many banks, some with infusions of capital from the federal government, were solvent and not about to collapse. Those first results significantly improved confidence in the financial system, a critical development in ending the crisis.

Equity capital has more than doubled at the larger banks.

This year's results will be announced by the Fed no later than June 30.

Meanwhile, regulators are constantly seeking ways to further reduce the risk of contagion, that is, the risk that if something goes wrong in one large bank, that as a result of its interconnections with other institutions, the problem will spread through the whole system. The latest rule, finalized in March, restricts the total credit exposure of one GSIB to another to 15 percent of its so-called Tier 1 equity capital. There is a 25 percent limit to any other type of counterparty. Other limits apply to large banks that are not GSIBs.

Another rule was proposed by the Fed last year to further increase required bank capital. It would require that GSIBs issue debt that could be converted to loss-absorbing capital if all of a firm's regular capital was wiped out by losses. "In effect," Yellen said, "this requirement provides a means for 'bailing in' a firm's long-term debt holders so that a taxpayer bailout will be unnecessary."

In addition to far more stringent rules and regulations applying to large banks, supervision of them is much more stringent as well. Prior to the crisis, teams of examiners worked separately at each of the very large banks and there was little coordination among them or sharing of what they were finding. Details of each bank's business remain private, but there is now an oversight committee that includes not just examiners but also other financial experts, Yellen said in her testimony. In addition to the usual firm-by-firm examinations, there are also "horizontal" exams in which all the firms are queried at the same time on the same set of issues to help gauge the stability of the financial system as a whole.

There is yet another requirement for GSIBs that few if any have met: drawing up a plan under which the firm could dissolve itself in an orderly way if it were to fail. "Requiring these firms to plan for an orderly resolution has forced them to think more carefully about the sustainability of their business models and corporate structures," Yellen said. "Nevertheless, while we have seen some evidence of improved risk management, internal controls, and governance at the [GSIBs], they continue to have substantial compliance and risk-management issues." The firms, she added, "must address these issues directly and comprehensively."

On April 13, the Fed and the Federal Deposit Insurance Corp. jointly announced that each of the resolution plans submitted last year by Bank of America, Bank of New York Mellon, JPMorgan Chase, State Street, and Wells Fargo "was not credible or would not facilitate an orderly resolution" under the bankruptcy code, the standard set by Dodd-Frank. They have until October to fix the problems. Any bank that does not "may be subject to more stringent prudential requirements," the press release said. The Fed and the FDIC also found problems with the plans of Goldman Sachs and Morgan Stanley, though the agencies did not agree on their shortcomings.

Citigroup did the best. The agencies agreed its plan was both credible and would facilitate an orderly resolution in bankruptcy, but there were still issues Citi had to address.

No one among U.S. financial regulators is about to promise that no very large financial organization will ever fail. Far from it. For instance, Thomas M. Hoenig, vice chairman of the Federal Deposit Insurance Corp. and a former president of the Kansas City Federal Reserve Bank, told a recent conference on bank supervision at the New York Fed that bank examinations should be more

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comprehensive and that bank management should be much more transparent about the condition of their institutions.

He also said that in his view, the largest banks' capital should be substantially greater.

There can be no doubt, however, that the risk of one of the GSIBs failing has been reduced very significantly. A large part of that improvement is due to the implementation of Dodd-Frank. The lengthy, sustained economic recovery from the severe recession the crisis caused has also made an enormous difference. At the end of last year, there was $8.84 trillion worth of loans outstanding and payments were past due on only 1.56 percent of them, according to the FDIC.

The most important issue in assessing the TBTF risks going forward is not whether taxpayers someday might have to finance a bailout. Rather, it is whether a failure might again threaten the financial system, cause bank credit to contract, and badly damage the economy. Or perhaps there was a sustained decline in world economic activity not necessarily precipitated by the banking system but that created a huge need for financial support from the central bank. Because of the political unpopularity of the crisis bailouts, the Fed's power to supply credit was significantly curtailed by Dodd-Frank.

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The famous section 13(3) of the Federal Reserve Act that effectively permitted loans to anyone—that was the authority invoked when credit was extended to AIG—was repealed. Fed officials have no such scenario in mind, but some fear such a time could come again, and Congress and the president would have to pass new legislation before the central bank could act.

Meanwhile, the first of the Minneapolis Fed symposia on TBTF was held in early April, and certainly no consensus was achieved. The published agenda listed two "featured" speakers, Anat R. Admati, a professor of finance and economics at Stanford University's Graduate School of Business, and MIT's Simon Johnson.

Both argued strongly that very large banks should be broken up. Johnson renewed an earlier proposal to limit any bank's assets to 2 percent of GDP. Interestingly, three of the ten banks on Johnson's list have not been designated as GSIBs, despite their size.

Some other speakers at the symposium disagreed that size alone was necessarily a problem, and that there could be significant costs associated with breaking up the banks.

Ross Levine, a banking and finance professor at the University of California at Berkeley, said, "It sounds good: 'If banks are too big to fail, make them smaller.' But where is the evidence that breaking-up-the-big-banks enhances banking services and economic prosperity?" he asked.

And Aaron Klein, policy director of the Initiative on Business and Public Policy at the Brookings Institution, said that one ought to ask four questions: Can I keep my bank? How does a global business such as 3M bank? What does this mean for U.S. capital markets and debt issuers such as Minnesota? Are we sure Dodd-Frank isn't solving the problem?

"A cap on size would inherently mean that millions of Americans would be forced to switch their banks once larger banks were forced to drop customers to conform with the size limits," Klein said. "Changing banks would impose both a one-time cost on millions of account holders and many would also incur more in ongoing fees and expenses that result from having access to smaller ATM networks, fewer convenient locations, and a lack of broader services." Similarly, Klein said, companies such as 3M likely would have higher costs, particularly for receiving and making international payments, and that borrowers would find U.S. capital markets less liquid and therefore debt issuance more costly.

Phillip Swagel, professor of international economics at the University of Maryland, said that the notion that "lots has been done" in dealing with TBTF "might push out the frequency of financial crises to every thirty years or every fifty years instead of every ten or twenty years. Maybe as a society we are willing to live with that—to pay the costs associated with a taxpayer bailout (including the political and societal costs). But let's make that explicit—do the calculation of the costs and benefits."

That's going to be difficult task, and certainly not one Sanders has contemplated. And one has to wonder if Kashkari and his colleague, Ron J. Feldman, the Minneapolis Fed's executive vice president and senior policy advisor, can as promised craft a plan for dealing with TBTF before the year is out. In 2004, Feldman was the co-author of *Too Big To Fail: The Hazards of Bank Bailouts,* with Gary H. Stern, then president of the bank.

Stern and former Fed Vice Chairman Donald L. Kohn were discussants of Kashkari's presentation at Brookings. Both said they preferred sticking with implementing Dodd-Frank rather than breaking up the banks. ◆