

**Testimony submitted to the Subcommittee on Financial Institutions and Consumer Protection, Senate Committee on Banking, Housing, and Urban Affairs, hearing on “A New Regime for Regulating Large, Complex Financial Institutions,” December 7, 2011 (embargoed until 10am)**

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of <http://BaselineScenario.com>.<sup>1</sup>

**Main Points**

- 1) Recent adjustments to our regulatory framework, including the “Dodd-Frank Wall Street Reform and Consumer Protection Act,” have not fixed the core problems that brought us to the brink of complete catastrophe in fall 2008:
  - a. Powerful people at the heart of our financial system still have the incentive and ability to take on large amounts of reckless risk – through borrowing large amounts relative to their equity. When things go well, a few CEOs and a small number of others get huge upside – [estimated at over \\$2 billion from 2000 to 2008](#) at the top 14 US financial institutions.
  - b. When things go badly, society, ordinary citizens, and taxpayers get the downside, including more than 8 million jobs lost and a medium-term increase in debt-to-GDP of at least \$7 trillion (roughly 50 percent of GDP).
- 2) This is a classic recipe for financial instability and fiscal calamity.
- 3) Our six largest bank holding companies currently have assets valued at close to \$9.5 trillion, which is around 62.5 percent of GDP (using the latest available data, from end of Q3, 2011). The same companies had balance sheets worth around 55% of GDP before the crisis (e.g., 2006) and no more than 17% of GDP in 1995.
- 4) With assets ranging from around \$800 billion to nearly \$2.5 trillion (under US GAAP), these bank holding companies are perceived by the market as “too big to fail,” meaning that they are implicitly backed by the full faith and credit of the US government. They can borrow more cheaply than their competitors – estimates place this advantage between 25 and 75 basis points – and hence become larger.
- 5) In public statements, top executives in these very large banks discuss their plans for further global expansion – presumably increasing their assets further while continuing to be highly leveraged. In its public statements, the US Treasury appears to endorse this strategy.

---

<sup>1</sup> This testimony draws on joint work with James Kwak, particularly [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#), and Peter Boone, including [Europe on the Brink](#). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at <http://BaselineScenario.com>, where we also provide daily updates and detailed policy assessments. For additional affiliations and disclosures, please see this page: <http://baselinescenario.com/about/>.

- 6) In this context, the Troubled Asset Relief Program (TARP) played a significant role preventing the deep recession of 2008-09 from becoming a full-blown Great Depression, primarily by providing capital to financial institutions that were close to insolvency or otherwise under market pressure. But these actions further distorted incentives at the heart of Wall Street. Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program put it well in his January 2011 [quarterly report](#), emphasizing: “perhaps TARP’s most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are ‘too big to fail.’”
- 7) To see just the fiscal impact of the finance-induced recession, consider changes in the CBO’s baseline projections over time. In [January 2008](#), the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to \$5.1 trillion by 2018 (23% of GDP). As of [January 2010](#), the CBO projected that over the next eight years, debt would rise to \$13.7 trillion (over 65% of GDP)—a difference of \$8.6 trillion.
- 8) Most of this fiscal damage is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the “automatic stabilizers” in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.<sup>2</sup>
- 9) In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States. It also damages the nonfinancial sector both directly – when there is a credit crunch, followed by a deep recession – and indirectly through creating a future tax liability.
- 10) In principle, Section 165 of Dodd-Frank strengthens prudential standards for large, interconnected financial institutions – including “nonbanks”. In practice, all the available evidence suggests that big banks and other financial institutions are still seen as Too Big To Fail. This is not a market; it is a large-scale, nontransparent, and unfair government subsidy scheme. It is also very dangerous.
- 11) There is nothing in the Basel III accord on capital requirements that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially raising capital requirements would not be costly from a social point of view (e.g., see [the work of Anat Admati of Stanford University and her colleagues](#)).

---

<sup>2</sup> See also the May 2010 edition of the IMF’s cross-country fiscal monitor for comparable data from other industrialized countries, <http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

- 12) But the financial sector's view has prevailed – they argue that raising capital requirements will slow economic growth. This argument is supported by some misleading so-called “research” provided by the Institute for International Finance (a lobby group). The publicly-available analytical work of the official sector on this issue (from the Bank for International Settlements and the New York Fed) is not convincing – if this is the basis for policymaking decisions, there is serious trouble ahead.
- 13) Even more disappointing is the failure of the official sector to engage with its expert critics on the issue of capital requirements. This certainly conveys the impression that the regulatory capture of the past 30 years (as documented, for example, in [13 Bankers](#)) continues today – and may even have become more entrenched.
- 14) There is an insularity and arrogance to policymakers around capital requirements that is distinctly reminiscent of the Treasury-Fed-Wall Street consensus regarding derivatives in the late 1990s – i.e., officials are so convinced by the arguments of big banks that they dismiss out of hand any attempt to even open a serious debate.
- 15) The purpose of the Volcker Rule (section 619 of Dodd-Frank, but also sections 620 and 621) is to restrict activities by large banks that have implicit government support. The legislative intent is to create an eminently sensible failsafe mechanism – to prevent speculative “proprietary trading” by banks that have implicit government support.
- 16) Unfortunately, the draft Volcker Rule-related regulations give undue primacy to preserving market structure “as is”. In particular, the Federal Reserve seems inclined to keep universal banks engaged in securities trading, regardless of the consequences for systemic risk. There are too many regulator created loopholes and exemptions. Systemically important nonbank financial companies should be included within the scope of the Rule. There should be better communication of what is and what is not proprietary trading – to ensure consistency across firms and integration with their reporting systems. There needs to be guidance on what constitutes significant loss and substantial risk. We also have no clear picture regarding how compliance would be enforced.
- 17) In any case, the Volcker Rule is a complement not a substitute for any other reasonable measures taken to reduce the dangers inherent in large-scale financial institutions.
- 18) Section 622 of Dodd-Frank, “Concentration Limits on Large Financial Firms” also held considerable promise – aiming to ensure that no one firm be able to “merge and consolidate” in such a way as to raise its share of “aggregate consolidated liabilities of all financial companies” above 10 percent. Unfortunately, there appears to be little or no willingness on the part of regulators for turning this in real rules that can be enforced. Big is still beautiful, it appears, in the eyes of key members of the Financial Stability Oversight Council.

- 19) Next time, when our largest banks get into trouble, they may be beyond Too Big To Fail. As seen recently in Ireland and as may now happen in other parts of Europe, banks that are very big relative to an economy can become “too big to save” – meaning that while senior creditors may still receive full protection (so far in the Irish case), the fiscal costs overwhelm the government and push it to the brink of default (or beyond).
- 20) The fiscal damage to the United States in that scenario would be immense, including through the effect of much higher long term real interest rates. It remains to be seen if the dollar could continue to be the world’s major reserve currency under such circumstances. The loss to our prestige, national security, and ability to influence the world in any positive way would presumably be commensurate.
- 21) In 2007-08, our largest banks – with the structures they had lobbied for and built – brought us to the verge of disaster. TARP and other government actions helped avert the worst possible outcome, but only by providing unlimited and unconditional implicit guarantees to the core of our financial system. At best, this can only lead to further instability in what the Bank of England refers to as a “[doom loop](#)”. At worst, we are heading for fiscal disaster and the loss of reserve currency status.
- 22) During the Dodd-Frank legislative debate, there was an opportunity to cap the size of our largest banks and limit their leverage, relative to the size of the economy. Unfortunately, the Brown-Kaufman Amendment to that effect was defeated on the floor of the Senate, 33-61, in part because it was opposed by the US Treasury.<sup>3</sup>

### **Resolution under Dodd-Frank**

The U.S. economic system has evolved relatively efficient ways of handling the insolvency of nonfinancial firms and small or medium-sized financial institutions. It does not yet have a similarly effective way to deal with the [insolvency of large financial institutions](#). The dire implications of this gap in our system have become much clearer since fall 2008 and there is no immediate prospect that the underlying problems will be addressed by the regulatory reform proposals currently on the table. In fact, our underlying banking system problems are likely to become much worse.

In spring 2010, during the Dodd-Frank financial reform debate – Senator Ted Kaufman of Delaware emphasized repeatedly on the Senate floor that the proposed “resolution authority” was an illusion. His point was that extending the established Federal Deposit Insurance Corporation

---

<sup>3</sup> See <http://baselinescenario.com/2010/05/26/wall-street-ceos-are-nuts/>, which contains this quote from an interview in New York Magazine: “‘If enacted, Brown-Kaufman would have broken up the six biggest banks in America,’ says the senior Treasury official. ‘If we’d been for it, it probably would have happened. But we weren’t, so it didn’t.’”

(FDIC) powers for “resolving” (jargon for “closing down”) financial institutions to include global megabanks simply could not work.

At the time, Senator Kaufman’s objections were dismissed by “experts” both from the official sector and from the private sector. The results are reflected in Title II of Dodd-Frank, “Orderly Liquidation Authority.”

Now these same people (or their close colleagues) are arguing resolution cannot work for the country’s giant bank holding companies. The implication, which these officials and bankers still cannot grasp, is that we need much higher capital requirements for systemically important financial institutions.

[Writing in the March 29, 2011 edition of the National Journal](#), Michael Hirsch quotes a “senior Federal Reserve Board regulator” as saying:

“Citibank is a \$1.8 trillion company, in 171 countries with 550 clearance and settlement systems,” and, “We think we’re going to effectively resolve that using Dodd-Frank? Good luck!”

The regulator’s point is correct. The FDIC can close small and medium sized banks in an orderly manner, protecting depositors while imposing losses on shareholders and even senior creditors. But to imagine that it can do the same for a very big bank strains credulity.

And to argue that such a resolution authority can “work” for any bank with significant cross-border is simply at odds with the legal facts. The resolution authority granted under Dodd-Frank is purely domestic, i.e., it applies only within the United States. The US Congress cannot make laws that apply in other countries – a cross-border resolution authority would require either agreement between the various governments involved or some sort of synchronization for the relevant parts of commercial bankruptcy codes and procedures.

There are no indications that such arrangements will be made – or that there are serious inter-governmental efforts underway to create any kind of cross-border resolution authority, for example, within the G20.

For more than a decade, the International Monetary Fund has been on the case of the eurozone to create a cross-border resolution mechanism of some kind within their shared currency area. But European (and other) governments do not want to take this kind of step. Rightly or wrongly, they do not want to credibly commit to how they would handle large-scale financial failure – preferring instead to rely on various kinds of ad hoc and spontaneous measures. The adverse consequences are apparent for all to see in Europe at present; yet there is still no move to establish a viable cross-border resolution authority.

I have checked these facts directly and recently with top Wall Street lawyers, with leading thinkers from left and right on financial issues (US, European, and others), and with responsible officials from the United States and other relevant countries. That Senator Kaufman was correct is now affirmed on all sides.

Even leading figures within the financial sector are candid on this point. Hirsch quotes Gerry Corrigan, former head of the New York Federal Reserve Bank, and an executive at Goldman Sachs since the 1990s.

“In my judgment, as best as I can recount history, not just the last three years but the history of mankind, I can’t think of a single case where we were able execute the orderly wind-down of a systemically important institution—especially one with an international footprint.”

It is most unfortunate that Mr. Corrigan did not make the same point last year – for example, when he and I both testified before the Senate Banking Committee on the Volcker Rule (in February 2010).

In fact, rather ironically in retrospect, Mr. Corrigan was among those [arguing most articulately that some form of “Enhanced Resolution Authority”](#) (as he called it) could actually handle the failure of Large Integrated Financial Groups (again, his terminology).

The “resolution authority” approach to dealing with very big banks has, in effect, failed before it even started.

And standard commercial bankruptcy for global megabanks is not an appealing option – [for reasons that Anat Admati has explained](#). The only people who are pleased with the Lehman bankruptcy are bankruptcy lawyers. [Originally estimated at over \\$900 million](#), bankruptcy fees for Lehman Brothers are [now forecast to top \\$2 billion](#) (more [detail on the fees here](#)).

It’s too late to re-open the Dodd-Frank debate – and a global resolution authority is a chimera in any case. But it’s not too late to affect policy that matters. The lack of a meaningful resolution authority further strengthens the logic behind the need for larger capital requirements, as these would provide stronger buffers against bank insolvency.

The Federal Reserve has yet to announce the precise percent of equity funding – i.e., bank capital – that will be required for systemically important financial institutions (so-called SIFIs). Under Basel III, national regulators set an additional SIFI capital buffer. The Swiss National Bank is requiring 19 percent capital and the Bank of England is moving in the same direction. The Fed should also move towards such capital levels or – preferably – beyond.

Unfortunately, there are clear signs that the Fed’s thinking – both at the policy level and at the technical level – is falling behind this curve.

It is not too late to listen to Senator Kaufman. In his capacity as chair of the Congressional Oversight Panel for TARP during 2011 (e.g., [in this hearing](#)), Mr. Kaufman argued consistently and forcefully for higher capital requirements. This would work as a global approach to make banking safer. Unfortunately, making progress on this issue with European countries will be much delayed – at least until the eurozone has sorted out its combined fiscal-monetary-financial disaster.

The best approach for the United States today would be to make all financial institutions small enough and simple enough so they can fail – i.e., go bankrupt – without adversely affecting the rest of the financial sector. The failures of CIT Group in fall 2009 and MF Global in fall 2011 are, in this sense, encouraging examples. But the balance sheets of these institutions were much smaller – about \$80 billion and \$40 billion, respectively – than those of the financial firms currently regarded as Too Big To Fail.