

Testimony submitted to the Subcommittee on Financial Institutions and Consumer Protection, Senate Committee on Banking, Housing, and Urban Affairs, hearing on “Examining the GAO Study on Government Support for Bank Holding Companies,” January 8th, 2014 (embargoed until 10am).

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A. Summary

- 1) The U.S. Government Accountability Office Report “Government Support for Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented” (GAO-14-18) provides some useful detail on the wide variety of support provided by the official sector to large bank holding companies during the financial crisis of 2007-10. The GAO is also correct that, even under the most favorable interpretation, there has been slow implementation of various key measures designed subsequently to make the financial system less risky. More than five years after the worst crisis since the 1930s, it is remarkable how little has been achieved by regulators.
- 2) The GAO report makes it clear that official sector support was provided disproportionately to some of the largest bank holding companies (and other large financial institutions) in the United States, because these firms faced very large (relative to firm size and relative to the macroeconomy) liquidity and solvency issues.
- 3) However, the report has seven prominent limitations that should be considered when we reflect on potential policy for the future:
 - a. There is insufficient consideration given to risk-adjusted returns. The GAO seems to accept at face value the Federal Reserve and Treasury position that “all of the Federal Reserve and F.D.I.C. assistance was fully repaid with interest.” But evaluating any such support as an investment should also involve consideration of the risks involved. For example, we could reasonably ask – what would the private sector have charged to provide this amount of funding under such terms, and on a risk-adjusted basis, what was the effective subsidy provided to big banks?
 - b. It does not consider the full scope of support provided by the Federal Reserve System, including the dollar value of allowing some financial sector firms to convert to bank holding companies at the height of the crisis.²

¹ Also a member of the Systemic Risk Council, a member of the Congressional Budget Office’s Panel of Economic Advisers, and a member of the F.D.I.C.’s Systemic Resolution Advisory Panel. All views expressed here are personal. 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 the global economy. For additional affiliations and disclosures, please see this page: <http://BaselineScenario.com/about/>.

² This point is mentioned in the report, but there is no attempt to provide a quantitative value for this important dimension of support. The firms involved, including Goldman Sachs and Morgan Stanley, may well have failed without this change in their legal status, which signaled that it would now be much easier for them to borrow from the Fed.

- c. It is also mostly silent on the ways in which monetary policy has become a mechanism for transferring wealth from savers to financial intermediaries, through very low interest rates.
 - d. There were alternative ways for the government to support the economy, including through “liquidity loans” to households who were underwater on mortgages. Was it cost effective for the government support banks directly and not provide substantial assistance to homeowners – many of whom would have experienced a recovery in asset values if they had been afforded loans on the kinds of terms available to large complex financial institutions?
 - e. It does not fully explore the full scope of US official support provided more indirectly to large foreign banks (e.g., through ensuring that AIG counterparties were paid in full), and the ways in which this did or did not help parts of the US financial sector.
 - f. It does not integrate a full analysis of the fiscal costs of the crisis, i.e., how much the government’s debt increased as a result of lost revenue and other impacts.³ The GAO report should therefore be read as measuring some “direct” costs of intervening to help large financial institutions, rather than as measuring the full cost to the taxpayer of the downside insurance provided by the official sector.
 - g. Perhaps most worryingly for the validity of future analysis, the GAO seems to weight all “expert” opinion equally, irrespective of whether the work in question was undertaken by people who work for big banks. In this context, I would flag the specific mention of work by the Bipartisan Policy Center on p.51, but this issue seems to come up throughout the report. If the GAO cannot sort out sensible analysis from sophisticated lobbying, then its important follow-up report on the current value of implicit subsidies to large banks is unlikely to have much value. The negative reputational effect on the credibility of the GAO, Congress, and the executive branch (including the Fed) would be considerable and most unfortunate.
- 4) To understand the full fiscal impact of the deep finance-induced recession, look at 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 will rise to \$13.7 trillion (over 65% of GDP)—a difference of \$8.6 trillion. Over the cycle, therefore, these CBO projections imply that debt relative to GDP will be 50 percentage points higher than it would be otherwise, as a direct result of the severity of the crisis.⁴
- 5) Excessive risk taking by large financial firms – including but not limited to U.S bank holding companies – was a central element of both the global credit boom in the years prior to 2008 and why the U.S. (and the world) experienced such a severe crisis after the collapse of Lehman Brothers.

³ In fairness, the GAO has attempted to deal with this broader issue in other work (e.g., see <http://www.gao.gov/products/GAO-13-180>).

⁴ Most of this fiscal impact 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.

- 6) Bailouts and myriad forms of downside protection extended to creditors, shareholders, and executives of large bank holding companies – and to non-banks that were allowed to become bank holding companies during the crisis – confirmed that some of these firms have become “too big to fail”. In the fall of 2008, top officials became convinced that allowing these firms to default on their obligations and potentially go bankrupt would worsen the global panic and damage the U.S. real economy.
- 7) Measures taken subsequently – including the Dodd-Frank financial reform legislation and actions by regulators – have been intended to reduce systemic risk and end the phenomenon of “too big to fail.” Unfortunately, as the GAO points out, relatively little progress has been made even within the framework of Dodd-Frank.
- 8) The remainder of this testimony assesses what should be done within or beyond the Dodd-Frank framework. Specifically, what we have learned over the past decade suggests that:
 - a. Requiring that all failing financial institutions go through bankruptcy, without any form of government support, is appealing but not likely to work with the current scale, scope, and complexity of large international financial institutions. Changing the bankruptcy code is unlikely to provide the kind of systemic stability that is desirable in a crisis – unless the official sector is again willing to step in with financing.
 - b. The Federal Deposit Insurance Corporation has made some progress with its Single Point of Entry approach to bank resolution. This could be helpful in some situations, but the F.D.I.C. is also likely to encounter serious implementation problems due to the difficulties of cross-border cooperation.
 - c. The living wills provision of Dodd-Frank has so far been interpreted very narrowly by regulators. The intent of the law is that every financial institution should be able to go bankrupt within the existing code, without that destabilizing the world economy. This is already the case for small and medium-sized financial institutions in the US; the problem is the largest handful of banks.
 - d. The logical requirement is that these banks should be limited in their scale, with a cap on the size of their non-deposit liabilities as a percent of GDP. There are some encouraging indications that the Federal Reserve is moving in this direction, but the pace of sensible change remains glacial.

B. The Problem with Bankruptcy

It is very appealing to simply say: we will never provide support to a failing financial company; all such companies must go through bankruptcy, just as non-financial companies do. And this is exactly the intent of Title I in Dodd-Frank.

Unfortunately, with the current scale, scope and complexity of very large financial institutions in the United States, this threat is not credible – meaning that it will likely not be carried out because it is not “time consistent”. Promises made today will not be implemented in a serious crisis because the consequences of following through would be too severe – and therefore officials will seek alternatives that involve some form of bailout.

These points became clear beyond a reasonable doubt at a public meeting at of the Federal Deposit Insurance Corporation’s Systemic Resolution Advisory Committee on December 11, 2013. Proponents of bankruptcy-as-a-viable-option acknowledged that this would require

substantial new legislation, implying a significant component of government support (or what would reasonably be regarded as a form of “bailout” to a failing company and its stakeholders).⁵

In other words, as matters currently stand – under the existing code or under any potential version of a “Chapter 14” that would preclude official financial support – bankruptcy for a big financial company would imply chaotic disaster for world markets (as happened after Lehman Brothers failed).

The proponents of bankruptcy readily acknowledged that handling the collapse of such a company in an “orderly” fashion – i.e., without causing global panic – would require a large amount of credit being made available to the relevant bankruptcy judge (or to some form of a court-appointed trustee).

But who could possibly provide the amount of credit necessary to be stabilizing, particularly at a moment of systemic nervousness or potential panic? The only potential credit source available would be the United States government, either through the Treasury Department or the Federal Reserve.

Under current legislation, providing such funding to a specific firm would be illegal. It would also be very awkward politically. Remember the justifiable resentment when Congress was asked to fund the \$700 billion Troubled Asset Relief Program in September 2008, to be run with the Treasury – initially with very little accountability. Now we are being asked to fund activities that are being overseen by bankruptcy judges (and trustees), who could decide, for example, to keep on current management. How would that play politically?

One argument is that such official loans would be “safe” because the government will definitely not lose the principal of its loan. But such assertions are not justified. Sometimes government emergency financial support can earn a decent risk-adjusted return, if troubled assets sufficiently recover their value. More often, the government ends up handing over a very large subsidy.

Bankruptcy cannot work for big banks – the largest half-dozen or so – at their current scale and level of complexity. It is not a viable option under current law. And changing the law to add a bailout component to bankruptcy – but only for very large complex financial institutions – does not pass the laugh test.

It is completely unrealistic to propose “fixing” this problem with legislation that would create a new genre of bailouts (or the pretense of “no bailout”, until the next crisis, where there would again be bailouts of the Paulson-Bernanke-Geithner variety).

Under current law – and as a matter of common sense – the Federal Reserve should take the lead in forcing megabanks to become smaller and simpler.

The legal authority for such action is clear. Under Section 165 of the 2010 Dodd-Frank financial reform legislation, large nonbank financial companies and big banks are required to create and

⁵ I’m a member of the committee, and [these points were covered](#) in the first session of the committee’s discussion on that day.

update “the plan of such company for rapid and orderly resolution in the event of material financial distress or failure.” The design is that this plan – known now as a “living will” – should explain how the company could go through bankruptcy (i.e., reorganization of its debts under Chapter 11 or liquidation under Chapter 7 of the Bankruptcy Code) without causing the kind of collateral damage that occurred after the failure of Lehman Brothers.

This bankruptcy should not involve any government support. It is supposed to work for these large financial companies just as it would for any company, with a bankruptcy judge supervising the treatment of creditors. Existing equity holders, of course, are typically “wiped out” – the value of their claims is reduced to zero.

The full details of these living wills are secret, known only to the companies and the regulators. (The Systemic Risk Council, chaired by Sheila Bair, [has called for greater disclosure of important details](#). I am a member of that Council.)

The discussion at the F.D.I.C. in December helped make clear that these living wills cannot be credible – either from a bankruptcy or resolution perspective – because the big banks are incredibly complex, with cross-border operations and a web of interlocking activities.

When one legal entity fails, this leads to cross-defaults – and then the seizure of assets around the world by various authorities and enormous confusion regarding who will be paid what. When any single megabank starts to go down, others will certainly come under intense market pressure, in part because the value of their assets will fall and in part because a sense of panic will spread – this is how such crises become “systemic”.

All of these effects are exacerbated by the fact that these companies are also highly leveraged, with much of this debt structured in a complex fashion (including through derivatives). The bankruptcy experts at the F.D.I.C. meeting stressed these points in fascinating detail.

What then are the implications? The Dodd-Frank Act has some specific language about what happens if the resolution plan of a nonbank financial company supervised by the Board of Governors or a bank holding company described in subsection (a) is not credible or would not facilitate an orderly resolution of the company.

Cross-border issues would be an insurmountable obstacle for bankruptcy with the current structure of large global financial firms. They would likely also create a major problem for any attempt to apply the F.D.I.C.’s preferred Single Point of Entry approach.⁶

Not unreasonably, under Section 165 of Dodd-Frank, the Fed and the F.D.I.C. may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth,

⁶ The F.D.I.C. has received an expression of potential cooperation from the Bank of England. Unfortunately, this and other vague statements are unlikely to hold up under the pressure of many real world situations. Only a binding treaty on cross-border resolution could really make a difference and this is unlikely for the foreseeable future.

activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies.⁷

The company may also be required “to divest certain assets or operations identified by the Board of Governors and the corporation, to facilitate an orderly resolution.”

The retort of the big banks is, “We can skip bankruptcy and go directly to Title II resolution,” which allows the F.D.I.C. to step in and take charge of a failing financial company. But the Title II (of Dodd-Frank) authority is intended as a back-up – to be used only if, contrary to expectations, bankruptcy does not work or chaos threatens.

If it is clear *ex ante* that bankruptcy cannot work – and this is now completely clear – then the implications of the statute are not controversial. The Fed and the F.D.I.C. must require remedial action, meaning that something about the size, structure and strategy of the megabanks must change.

This is the logic of our current situation. Section 165 is potentially valuable, but only if the relevant officials recognize this reality and act on it – precisely with the goal of making bankruptcy under the existing code into a feasible option for all firms in the US economy.

C. Assessment of the Volcker Rule

The announcement in December 2013 of the Volcker Rule, restricting proprietary trading and limiting other permissible investments for very large banks, is a major step forward. Almost exactly four years after the general idea was first proposed by Paul A. Volcker, the former chairman of the Federal Reserve, and nearly three and a half years since it became law, the regulators have finally managed to produce a rule.

This rule could be meaningful, and this is why there has already been so much pushback from the big banks. Their main strategy so far – denial that there is a problem to be addressed – has failed completely. Their legal challenges are also unlikely to succeed. The main issue now is whether the regulators force enough additional transparency so that it is possible to see the new ways that proprietary bets are hidden.

The Volcker Rule is intended to impact only the very largest banks – the material impact will be mostly on JPMorgan Chase, Bank of America, Citigroup, Goldman Sachs and Morgan Stanley. The goal is simple and sensible. Given that these banks are supported by large implicit government backstops (e.g., from the Federal Reserve), they should be more careful in their

⁷ For the F.D.I.C.’s approach to resolution to work, there has to be enough “bailinable debt” and equity at the holding company level. The Federal Reserve has yet to issue proposed rules for comment on this key topic – and their slowness on this issue is a matter for grave concern. It also remains to be seen what is really “bailinable debt” – what kinds of investors can own this without raising concerns of contagion and systemic risk when and if this debt is converted to equity (or is just wiped out) in a crisis.

activities and should not engage in large-scale bets that have the potential to cause insolvency for them and disruption for the rest of the global financial system.

These companies could choose to become smaller, with the constituent pieces operating under fewer restrictions. But their managements want to stay big, so they should face additional constraints.

The first pushback strategy – and the main focus of big bank efforts to date – is to deny that the Volcker Rule is needed at all. This line has been pushed hard over the last four years, including at a Senate hearing in February 2010.

Barry Zubrow, then chief risk officer at JPMorgan Chase, [testified that the Volcker Rule was not needed](#), as risk controls in big banks were sufficient to the task. (I also testified at the hearing, in favor of the rule.) The extent to which JPMorgan Chase subsequently managed its own risks – including proprietary trading-type activities run out of its chief investment office – [has been called into question](#). Mr. Zubrow retired at the end of 2012, [telling his colleagues](#), “We have learned from the mistakes of our recent trading losses.”

I hope that is true, but it seems unlikely, because the name of the game for very large banks is leverage, i.e., taking big bets using a lot of borrowed money and very little equity.⁸ This is how to boost your return on equity, unadjusted for risk, which is what financial analysts (and the related news coverage) focus on. Most regulators now have this point much more clearly in their minds.

At the same time, Mr. Zubrow and others asserted that the introduction of any kind of Volcker Rule would have a big negative effect on financial markets and the economy. But as the adoption of the rule has approached, financial markets have taken that news completely in stride. Yes, we have lower employment levels than we would like, but that’s primarily due to the large financial crisis since the Great Depression, brought on by excessive risk-taking (for example, at Citigroup).

The conceptual fight against the Volcker Rule has been lost by the big banks, at least in part because of the [London Whale](#) losses overseen by Mr. Zubrow and his colleagues – but also because enough regulators have finally wised up to how the big banks really operate and why that can damage the real economy.

Treasury Secretary Jack Lew also deserves credit for pushing the rule toward the finish line and for insisting that top management be held accountable for whether companies comply with the law.

⁸ On this point, see Anat Admati and Martin Hellwig, [The Bankers’ New Clothes: What’s Wrong with Banking and What to Do about It](#), Princeton University Press, 2013. A close reading of this book suggests that the recently proposed supplemental leverage ratio is a step in the right direction – but only a small step that is likely to prove insufficient. The increase in capital requirements under Basel III is also unlikely to make much difference – one senior official recently described this as moving maximum permissible leverage (debt relative to total assets) from 98-99 percent pre-2008 to around 97 percent for the future.

The second pushback strategy is legal – to bring one or more cases through the courts that will challenge key aspects of the Volcker Rule. Eugene Scalia, the son of Supreme Court Justice Antonin Scalia, has had some success with this strategy on other financial regulatory matters.

But, as former Congressman Barney Frank has pointed out, the new Senate rules mean that we should expect confirmation of three new judges on the U.S. Court of Appeals for the District of Columbia Circuit, which is where the Volcker Rule would need to be challenged. The chances of a successful legal case have therefore receded, although what happens when and if such a matter reaches the Supreme Court remains unclear.

The third strategy is to find new ways to hide the essence of proprietary trading – and this is an important open issue. Will there be enough disclosure and observable behavior for either the regulators or people on the outside to see whether the spirit of the Volcker Rule is being followed? For example, how exactly will traders be compensated and how much of this will be disclosed? Will data be available on trading activities, allowing independent researchers to look for patterns that might otherwise elude officials?

The Volcker Rule could be a major contribution to financial stability. Or it could still flop. The devil now is in the details of implementation and compliance – and how much of this becomes public information and why what time lag.

D. Some Limited Grounds for Optimism

There are some recent indications of changes in thinking at the most senior levels of the Federal Reserve System.

Specifically, beginning in October 2012, Governor Daniel K. Tarullo has articulated the potential case for limiting the size of our largest banks, measured in terms of their non-deposit liabilities as a percent of GDP.⁹

First and foremost, the Fed has begun to recognize and discuss publicly the implicit subsidies that large banks continue to receive,

“To the extent that a growing systemic footprint increases perceptions of at least some residual too-big-to-fail quality in such a firm, notwithstanding the panoply of measures in [the] Dodd-Frank [Act] and [Federal Reserve] regulations, there may be funding advantages for the firm, which reinforces the impulse to grow. There is, then, a case to be made for specifying an upper bound [on size].”

The implication is that we should not allow the size of our largest bank holding companies to increase further, although Mr. Tarullo seems to want to pass the buck back to Congress.

⁹ See <http://www.federalreserve.gov/newsevents/speech/tarullo20121010a.htm>. He made similar points in a speech at the Brookings Institution in December 2012 and in testimony before the Senate Banking Committee in February 2013.

“In these circumstances, however, with the potentially important consequences of such an upper bound and of the need to balance different interests and social goals, it would be most appropriate for Congress to legislate on the subject. If it chooses to do so, there would be merit in its adopting a simpler policy instrument, rather than relying on indirect, incomplete policy measures such as administrative calculation of potentially complex financial stability footprints. *The idea along these lines that seems to have the most promise would limit the non-deposit liabilities of financial firms to a specified percentage of U.S. gross domestic product, as calculated on a lagged, averaged basis.* In addition to the virtue of simplicity, this approach has the advantage of tying the limitation on growth of financial firms to the growth of the national economy and its capacity to absorb losses, as well as to the extent of a firm’s dependence on funding from sources other than the stable base of deposits. While Section 622 of Dodd-Frank contains a financial sector concentration limit, it is based on a somewhat awkward and potentially shifting metric of the aggregated consolidated liabilities of all ‘financial companies.’” (emphasis added)

Hopefully, there will be support for legislation along exactly these lines – as proposed by Senator Sherrod Brown and by Senator Brown with Senator David Vitter.¹⁰

The Federal Reserve could help articulate the case for such legislation with greater clarity.

It would also be most helpful if a vice chairman for supervision could be appointed to the Federal Reserve Board. The creation of this position is a requirement of the Dodd-Frank Act that, rather inexplicably, remains completely unaddressed by the Obama administration.

¹⁰ See the proposed [SAFE Banking Act proposal](#) and [TBTF Act](#).