“Reducing Too Big to Fail Subsidies by Changing Incentives”

Written Testimony of

Dr. Harvey Rosenblum*

Adjunct Professor of Finance
Cox School of Business
Southern Methodist University

Former Director of Research
Federal Reserve Bank of Dallas

U.S. Senate Committee on Banking, Housing, and Urban Affairs,
Subcommittee on Financial Institutions and Consumer Protection

Hearing on
“Examining the GAO Report on Government Support for Bank Holding Companies”
Part One of a Two-Part Study

Washington, DC
538 Dirksen Senate Office Building
January 8, 2014

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee:

I am pleased to testify on Too Big to Fail ("TBTF") subsidies and related issues stemming from the 2008-09 Financial Crisis. In doing so, I will indirectly comment on some of the more glaring inadequacies of the Dodd-Frank Act which, though well-intentioned, simply will not end TBTF. Dodd-Frank leaves the U.S. and global financial systems more crisis-prone than previously. To end TBTF and the financial instability it engenders, it is necessary that Congress amend the laws and incentives governing the provision of financial services by following a few basic principles.

First, ***incentives matter***. Dodd-Frank has done little to alter the widespread perception that the U.S. Treasury and the Federal Reserve will once again provide extraordinary government assistance to giant financial institutions that get themselves into financial trouble. Promises to end TBTF are easy to make, but like all promises, are difficult to keep in the face of a financial crisis. The stockholders, creditors, and other counterparties of giant financial institutions know this—and act accordingly. This perception enables giant financial institutions to grow faster, larger and more dangerously than smaller institutions and provides a distinct cost advantage to the giants. This is the source of a huge $50-100 billion annual subsidy that flows to the giant financial institutions in perpetuity. [Bank for International Settlements, 2012]

Congress has never voted to approve this annual expenditure; it came about inadvertently as technology changed, Congress allowed interstate banking, and Congress ended the separation between investment banking, insurance and commercial banking. The net result is that public policy now subsidizes the growth of large, risky, and unmanageable financial institutions that create systemic financial instability, the <u>opposite</u> of what public policy professes to seek to achieve.

Second, ***initial conditions matter***. Fewer than a dozen giant banking institutions control around 70 percent of industry assets, up considerably from the years just prior to the financial crisis. Our financial services industry has gotten more concentrated; the playing field is less level; and government policy, perhaps unintentionally, will continue to foster ever more consolidation, concentration, and reduced competition in financial services. To believe otherwise requires a willful blindness to what should be obvious to observers of our financial system. As Yogi Berra once said: "Sometimes you can observe a lot, just by looking."

Competition is being further reduced by a merger and acquisition wave among small-to-medium size banking institutions in response to the enormity of the regulatory compliance costs of dealing with Dodd-Frank. In addition, new entry into banking has been at a near-standstill for the last five years. In these circumstances, it would be wishful thinking on my part to believe that the normal forces exerted by capitalism and free markets are capable of reversing these competitive imbalances.

Economics 101 teaches us that proper incentives and competition allow market forces to solve most economic problems. Banking is plagued by the perverse incentives of TBTF, combined with ever-diminishing competition.

When all of the costs of the 2008-09 Financial Crisis are added up, the costs to the United States will amount to $15-30 Trillion. [Atkinson, Luttrell and Rosenblum, 2013] Yes, I said *trillion*. This is one-to-two years of U.S. output down the drain. Allow me to translate this into everyday language the average person can understand; a conservative estimate is that the crisis cost $50 thousand to $120 thousand for every U.S. household. [Luttrell, Atkinson and Rosenblum. 2013] Many of these costs were largely avoidable. What is worse, unless government policies and incentives on TBTF subsidies are changed, another financial crisis, likely worse than the last one, may occur in the not-too-distant future.

The TBTF Subsidy. I commend the recent GAO study of the TBTF subsidy. [GAO, 2013] As you know, the GAO's study is part one of a two-part study quantifying the subsidy received by the surviving TBTF firms. The study quantifies the financial benefits conferred on the TBTFs during the financial crisis. Part two, the more important study, will measure the ongoing subsidy received by the TBTFs post-crisis.

This subsidy is large, though its exact size varies from year-to-year and business cycle to business cycle. The subsidy grossly distorts normal market forces. As one observer has noted, the subsidy serves as a "shadow poison pill" not only making the TBTF firm immune to corporate threats but degrading the customary governance forces that would lead to the right-sizing of the firm [Roe, 2013]

The subsidy, moreover, enables the giant banks to grow larger and more dangerous to our economic system; but it is difficult to measure precisely. There is no line item on a bank's balance sheet or income statement labeled "TBTF Subsidy." But it exists and it is pernicious in its impact. It is legal; the giant financial institutions are merely responding to the incentives presented to them, not necessarily violating any laws.

The TBTF subsidy, in theory, should accrue to the equity shareholders of the giant banking institutions. In practice, a substantial portion of the TBTF subsidy is dissipated away in the form of higher management salaries, bonuses and perquisites; inefficient operations; and corporate waste. Unlike other industries, hostile takeovers by corporate raiders, hedge funds and private equity firms are impossible in the case of giant banking institutions. Short of a government-ordained merger in the face of an impending failure, there is simply no market mechanism to effectuate a change in corporate control at the largest banking institutions.

Restoring Competition and Reducing TBTF Subsidies. Recently, I was the co-author of a plan that sought to utilize market forces to reduce the TBTF subsidy, level the competitive playing field in banking, and most importantly, lessen the likelihood of incurring another round of horrendous costs from another avoidable financial crisis. [Fisher and Rosenblum, 2013a] As a nation, we simply cannot afford to repeat previous mistakes.

The reform plan we advocated—which has since become known as "the Dallas Fed Plan,"—would: 1) restrict the federal safety net of deposit insurance and access to the Federal Reserve's lender of last resort facilities to traditional depository institutions; 2) require every customer of nonbank financial institutions to acknowledge in writing that the U.S. government provides absolutely no backstop or financial guaranty for their transactions; and 3) call for government policies that strongly encourage the managements of the nation's largest banking institutions to streamline, simplify and downsize their companies so that any and all banking affiliates of the financial holding company would be certified by the FDIC as "Too Small to Save" in the event of failure. These three steps would realign incentives away from the current perverse TBTF mindset and would re-establish a more competitive framework within the banking industry. Dallas Fed President Richard Fisher continues to advocate the Dallas Fed Plan. To some extent, several of the giant institutions have begun downsizing and streamlining, but at a snail's pace [Fisher and Rosenblum, 2013b], a process that the stock market, by way of price-to-tangible book value ratios, is urging management to pursue [Fisher and Rosenblum, 2013c].

Would the Dallas Fed Plan end banking and financial crises? Probably not; financial crises have characterized the global banking and financial system for over three centuries and will likely continue to do so. However, I firmly believe that the Dallas Fed Plan, which operationally could be thought of as a plan to mitigate moral hazard, would considerably reduce the frequency and severity of financial crises in the United States. No financial reform plan is perfect, but we should not let our quest for perfection distract us from making significant improvements to the architecture of our financial system.

Alternative Means to Reduce the Impact of TBTF Subsidies. I believe the Dallas Fed Plan is the best financial reform plan. But there are several other good reform plans worthy of consideration. I will mention two that would reinforce the virtues of the Dallas Fed Plan by helping to get the incentives right and by having the additional benefit of enforceability due to their transparency and simplicity.

One is the Subsidy Reserve Plan advocated by Boston University Professor Cornelius Hurley. This plan is the subject of legislation (H.R. 2266) filed by Congressman Michael Capuano in 2013.

Professor Hurley's plan would require the GAO, together with the Federal Reserve and the Office of Financial Research to determine the size of the TBTF subsidy for each of the giant banking institutions, and then lock up that amount so that it could only be distributed to shareholders and other stakeholders in connection with the downsizing of the TBTF firms. [Hurley, 2013] The appeal of this plan is its reliance on market discipline as opposed to arbitrary break-up plans and caps on growth.

While I can imagine intense debate over determining the acceptable methodology for measuring the TBTF subsidy, I still believe the Subsidy Reserve Plan has a lot of merit. Part two of the GAO's study due later this year may be an important milestone in advancing our understanding of the TBTF subsidy.

In any event, recent-day banking regulation is plagued by endless debate over how much bank capital is "adequate," as well as which categories of capital qualify for covering losses. After more than a century, measuring the adequacy of bank capital remains a continuing debate. As with capital requirements, the most important thing is not that we measure the subsidy with scientific precision but that we ensure that our quantification of the subsidy is directionally accurate.

In this context, I should mention the Brown-Vitter Bill, which seeks to impose a 15 percent capital-to-assets ratio on all giant banking institutions, a ratio much higher than has been imposed or voluntarily adhered to by banking institutions for over half a century, if not longer. [Brown and Vitter, 2013] For most banking institutions, a 15 percent capital-to-assets ratio seems to me to be too high. For the giant banking institutions, however, a 15 percent capital-to-assets ratio seems to be barely adequate given the systemic repercussions that would follow the failure of such a giant banking institution.

We sometimes set different highway speed limits for 18-wheelers carrying hazardous substances than we do for automobiles carrying a few passengers. We also do not encourage self-regulation of speed limits by drivers. Perhaps this analogy provides some lessons for the necessary transparency, simplicity, and enforceability of capital regulations for banks. Let me conclude with a sweeping but appropriate generalization: when it comes to regulation of the banking industry in general, and capital in particular: complexity is the enemy. Complexity makes regulation unintelligible and thereby unenforceable; it can sometimes be worse than no regulation at all. Let me be more specific—the Basel rules on bank capital regulation and Dodd-Frank have caused more harm than good. Basel rules have encouraged institutions to load up on "safe" assets like mortgage securities and sovereign debt, and Dodd-Frank, three and a half years after being signed into law, is only about halfway through its regulation-writing phase and has already produced more than 14,000 pages of proposed regulations.

Back to the Drawing Board: If It Is Not Workable, It Simply Will Not Work. I know it is difficult for those who supported Dodd-Frank to acknowledge its largely unworkable nature. Delegating rule-writing responsibility to more than a dozen agencies has produced irrational unaccountability. The perverse incentives of TBTF have been perpetuated and hidden within thousands of pages of inscrutable regulations confounded by conflicts and complexity. The regulations are simply a kaleidoscopic reflection of the underlying statutes.

There is a simpler and better alternative. The Dallas Fed Plan, perhaps combined with the Subsidy Reserve Plan and the Brown-Vitter Bill, could postpone the next financial crisis for a decade or two. This would require, however, that the resulting statute is no more than about ten pages long, with the added requirement that its resulting regulations must be written using fewer words than the statute.

*****The views expressed are my own and are not necessarily those of the Federal Reserve Bank of Dallas or the Federal Reserve System where I worked for over 40 years before retiring on Nov. 1, 2013.

REFERENCES

Atkinson, Tyler, David Luttrell, and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis," Federal Reserve Bank of Dallas, *Staff Papers*, July 2013.

Bank for International Settlements, BIS Annual Report 2011/12, June 24, 2012, p. 75-6.

Brown, Sherrod and David Vitter, *Terminating Bailouts for Taxpayer Fairness Act* (TBTF Act), S. 798, 2013.

Fisher, Richard and Harvey Rosenblum (2013a), "Vanquishing Too Big to Fail," Federal Reserve Bank of Dallas, *2012 Annual Report*.

Fisher, Richard and Harvey Rosenblum (2013b), "Why we must downsize banking behemoths into 'too small to save' entities," *Dallas Morning News*, Sept. 12, 2013.

Fisher, Richard and Harvey Rosenblum (2013c), "A Credible Path for Ending Too Big to Fail," *Business Economics*, Vol. 48, No. 3, p. 167-73.

GAO, "Government Support for Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented," GAO-14-18, November 2013.

Hurley, Cornelius, "End 'Too Big to Fail' by Making It Shareholders' Problem," *American Banker*, January 23, 2013.

Luttrell, David, Tyler Atkinson and Harvey Rosenblum, "Assessing the Costs and Consequences of the 2007-09 Financial Crisis and Its Aftermath," Federal Reserve Bank of Dallas, *Economic Letter*, Vol. 8, No. 7, September 2013.

Roe, Mark J., "Structural Corporate Degradation Due to Too-Big-to-Fail Finance," *University of Pennsylvania Law Review*, forthcoming, (Draft dated November 7, 2013).