

Leveling the Playing Field

By Harvey Rosenblum

Financial reform must be redirected. The government's financial safety net for the biggest banks should cover only their essential banking activities and their role in the payments system. Once that occurs, market discipline can reassert itself, and all institutions—large and small—can compete on a more level playing field.

Market discipline, an essential tenet of capitalism, restrains excessive risk taking. It relies on stockholders, creditors and managers believing they're exposed to losses from ill-advised decisionmaking. Penalties for reckless behavior include lost business, higher borrowing costs and falling stock prices; the ultimate punishment is outright company failure. Fear of adverse consequences provides incentives for prudent actions.

The opposite also holds, of course. Erosion of market discipline could lead to impetuous, short-sighted decisions or strategic decisions that take advantage of the lower funding costs stemming from the implied safety net. In the banking sector, market discipline began to fade with implicit extensions of the federal safety net. The growing perception of a protective umbrella over the nation's biggest banks further weakened market discipline. The big banks became "too big to fail" (TBTF)—insulated from the consequences of ill-advised behavior and bad decisions.

Thus shielded, they could raise funds at lower cost, gaining a distinct and sustainable competitive advantage that has driven the country toward ever greater financial industry consolidation. Left behind were America's small and midsized banks, struggling to maintain market share even though they largely stuck with traditional banking activities and contributed little to the financial markets' near-meltdown in 2008.

For well over a century, the banking industry has been subject to regulatory discipline; that is, a legal code that guides behavior, supplemented by supervisory oversight designed to impose prompt corrective action for rules violations. When such intervention fails, regulators shut down banks, or transfer their ownership, to protect depositors from losses. Today, nearly all banks—with the exception of those few deemed TBTF—are subject to the external forces of market and regulatory discipline. This TBTF exception is untenable and needs to be addressed.

Risk Assessment

To analyze how market and regulatory discipline limit excessive risk taking, banks have been assigned to one of three groups:

- The roughly 5,500 small community operations that hold about one-eighth of all bank organization assets
- A middle group of roughly 70 midsized, regional institutions with about one-fifth of industry assets
- The 12 largest banking institutions with more than two-thirds of industry assets

Small Banks: Brutal Efficiency

The smallest group faces varying degrees of pressure from market discipline. The lion's share of deposits is FDIC-insured, so depositors have little incentive to monitor the banks' risk profile. Many of the smaller institutions have few shareholders, some of whom have a significant portion of their wealth invested in the bank's stock. These shareholders have strong incentives to monitor and influence the risk profile. Minority shareholders have the same incentive because of the difficulty of selling their stock; it trades rarely in an illiquid market, especially when bank earnings are squeezed.



(Continued from *Financial Stability: Traditional Banks Pave the Way - Leveling the Playing Field*)

In spite of considerable shareholder-imposed market discipline, small banks can and do encounter problems. For troubled small banks, regulatory discipline works with brutal efficiency—FDIC teams often arrive on Friday and a new bank opens on Monday, with new owners and managers and no losses to insured depositors. In just the past few years, more than 400 such banks have been closed and subjected to ownership transfer, with shareholders essentially suffering total losses.

Midsized Banks: Restraint Imposed

Midsized regional banks face the industry's greatest market discipline. They often have significant deposits that aren't fully insured and some unsecured debt that would be subject to loss if failure occurred. While their size, geographic reach and product scope make them difficult to close and transfer to new owners over a weekend, many midsized institutions have experienced regulatory discipline in recent decades. So stakeholders—shareholders and uninsured creditors—have enough skin in the game to understand their vulnerability, and they're likely to impose some risk-restraint on bank management. Good executives know this, and it guides their decisions.

Big Banks: Discipline Diluted

For the 12 biggest banks, the perception of TBTF dilutes market discipline. What little market discipline that may have existed prior to the financial crisis of 2008–09 was undermined by the hundreds of billions of dollars of extraordinary government assistance and depositor and creditor guarantees heaped on these huge institutions. The media's incessant use of the word "bailout," coupled with the fact that these big banking firms never formally failed and still exist under the same names and stock-trading symbols, has likely resulted in a *misplaced perception* that their shareholders were protected from losses.

This has reinforced the view that supervisory agencies are powerless because of an inability to impose regulatory discipline. The sheer size of the biggest banks is daunting. On top of that, these institutions are unimaginably complex, with thousands of subsidiaries spread across the globe and roots sunk deeply into the economies of dozens of countries. Regulators couldn't deal with one of these huge banks in a weekend—or even in a month of weekends. Immense size and geographic reach also provide access to political power, so complaints about regulators will be heard. All told, the biggest banks are little constrained by market discipline or the threat of failure (*Table 1*).

Restoring Market Discipline

Purging the financial system of these dangers requires reducing the incentives for excessive risk by resurrecting market discipline. The first step involves recognizing the **moral hazard** inherent in the financial safety net, which should be rolled back to explicitly cover only activities essential to commercial banks and their role in the payments system.

This narrowly defined safety net should include federal deposit insurance and access to the Federal Reserve's lender-of-last-resort facilities, but it shouldn't extend to:

- Bank holding companies
- Broker-dealers
- Insurance subsidiaries
- Finance companies
- Any other nonbank entities

The limits of the safety net should be clearly delineated and credible—put in a one-sentence disclosure statement that's in bold type and capital letters, to be signed by all parties.

With a limited and proper safety net, some of the artificial advantages of size will fade and market discipline will eventually reassert itself.

(Continued from Financial Stability: Traditional Banks Pave the Way - Leveling the Playing Field)

Market discipline and its positive incentives could help reduce the size of the biggest banks by penalizing excessive risk taking and mind-numbing complexity. Just as important, small and medium-sized institutions will have a fairer opportunity to compete for market share—if they continue offering less risk and complexity.

Market discipline works elsewhere in the U.S. economy. Facing make-or-break market pressures, industries continually restructure, refocus, streamline and reorganize—such activities are routine and healthy in a capitalist system. If insiders grow complacent, companies end up undervalued, making them tempting targets for investors seeking to unlock shareholder value by breaking up the enterprises into smaller, more economically viable and manageable pieces. Looking at the largest U.S. banking companies, recent stock prices suggest that markets have a gloomy view of bigness (*Chart 1*).

Clear and Present Danger

Regulatory policy and public policy constrain how much and how rapidly corporate control can change—especially in the biggest institutions. A serious concern, therefore, is that market discipline will take too long to cut the biggest operators down to size—a time during which the economy could face the threat of another financial crisis, this one possibly worse than the last. Policy interventions—for example, a cap on bank size—might be needed to reach the point where any bank, even the largest ones, can fail without endangering the economy.

Defenders of the status quo argue that breaking up big banks would be costly and disruptive. Objections include:

- Inconvenience to customers
- The loss of big banks' size and scope in an era of global business
- A potential shift of business to foreign banks

Moreover, new regulations that address post-financial crisis concerns are scheduled to begin taking effect over the next few years. A case could be made for giving them a chance to work, even if it means tolerating colossal financial institutions.

These arguments ignore a reality: TBTF banks pose a clear and present danger. They've grown large and dominant through favorable government policies. Leveling the playing field will give smaller institutions a fair shake and enhance financial and economic stability.

The 2008 financial crisis cost the U.S. economy \$10 trillion to \$20 trillion in lost output, reduced wealth, extended unemployment, diminished opportunities and increased costs to taxpayers to fund extraordinary government intervention programs. The crisis left the banking industry more concentrated than ever. The Big Five bank holding companies control over half of industry assets. The next crisis could be more costly and bring further consolidation—a Big Two, perhaps, with 65 percent. What's after that—possibly a single dominant banking institution with market share much greater than we would have ever imagined before the financial crisis?

Big isn't always best. Doing nothing will court disaster. The TBTF problem is neither impossible nor too hard to fix; meanwhile, TBTF banks remain too dangerous to ignore.

About the Author

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Table 1
Megabanks Face Least External Discipline

Bank size and complexity vs. impact of external discipline					
				Market discipline from:	
	Can fail outright?	Speed of resolution	Regulatory discipline	Shareholders	Unsecured creditors
Community banks (5,500)	Yes	Weekend	Often significant	Some, often considerable	Too few to matter
Regional/moderate-sized banks (70)	Yes	Few weeks to 18 months	Significant, but slow	Significant, but lagged	Some, possibly significant
Megabanks (12)	No	Never closed	Insufficient, may be ineffective	Limited	Perverse

NOTE: Numbers shown in parentheses are the approximate (rounded) number of bank organizations in each cohort as of June 30, 2012.

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.

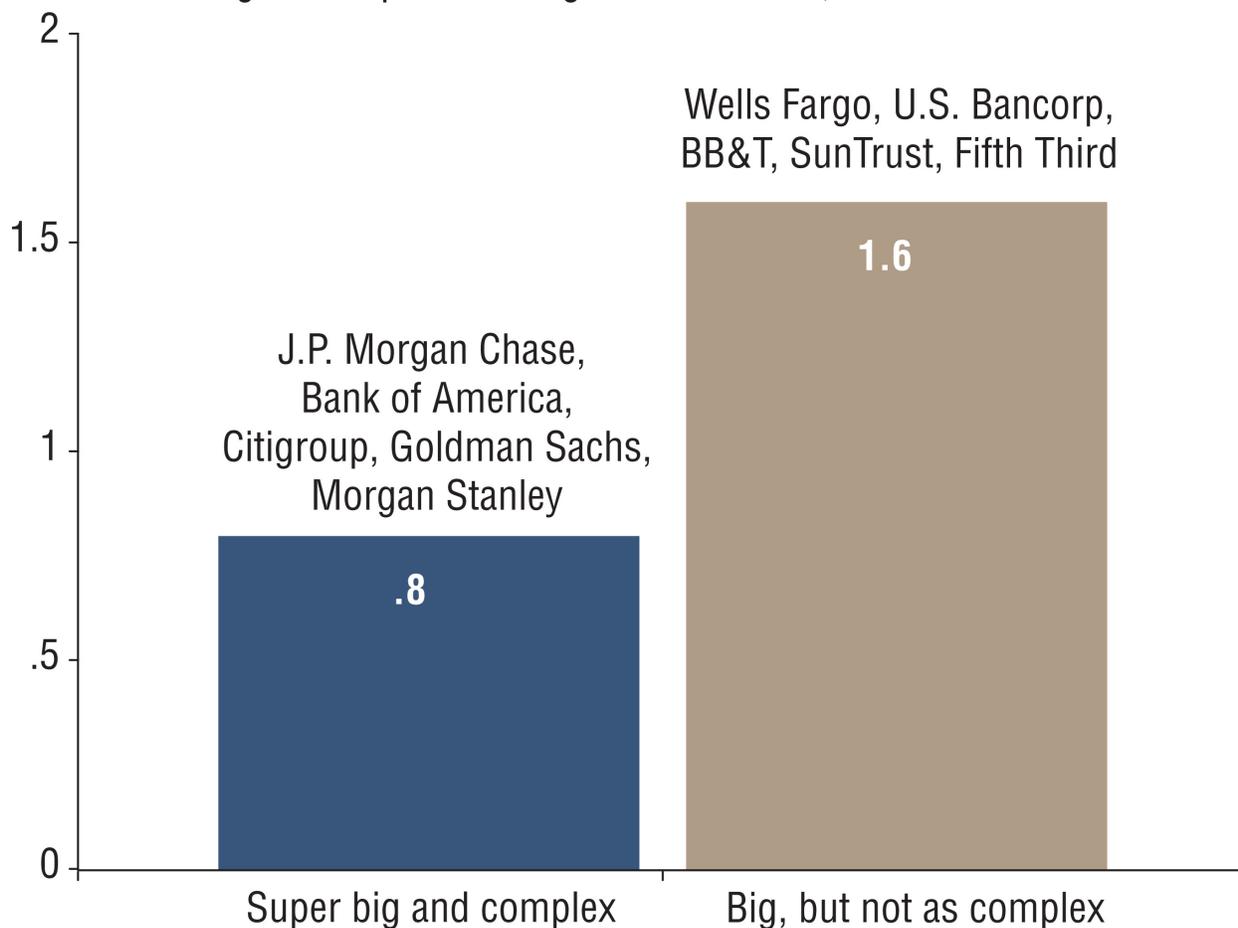
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Chart 1

Markets Reward Reduced Complexity

Ratio of average stock price to tangible book value, October 2012



NOTE: The “big, but not as complex” group includes banks larger than \$100 billion in assets and predominantly driven by commercial/retail banking activities rather than global banking or investment services and management.

DATA SOURCES: Bloomberg; author’s calculations.