Break Up the Big Banks: The Key to Economic Prosperity and Improved Financial Stability

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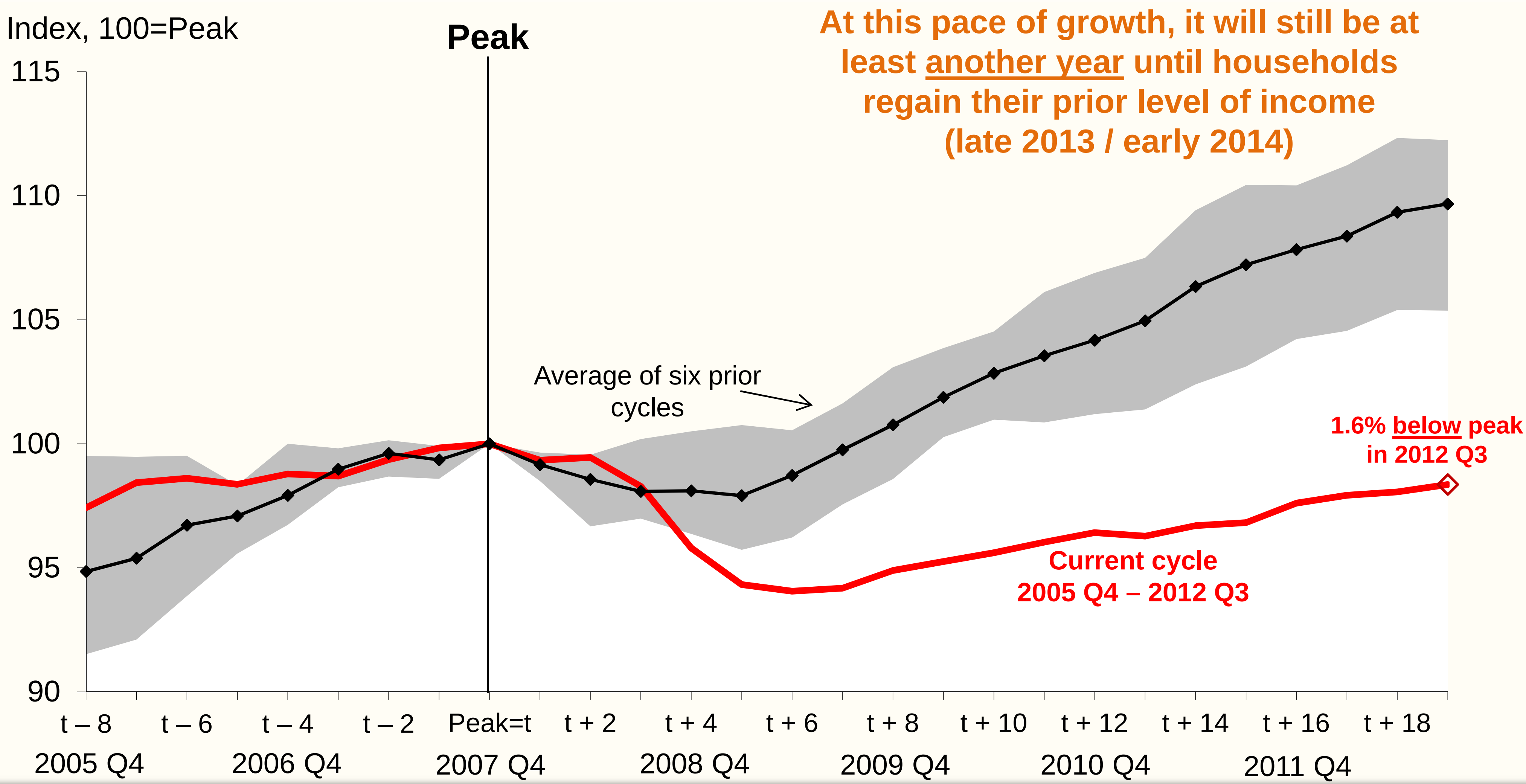
Richard W. Fisher
President and CEO

Harvey Rosenblum
Executive VP and Director of Research

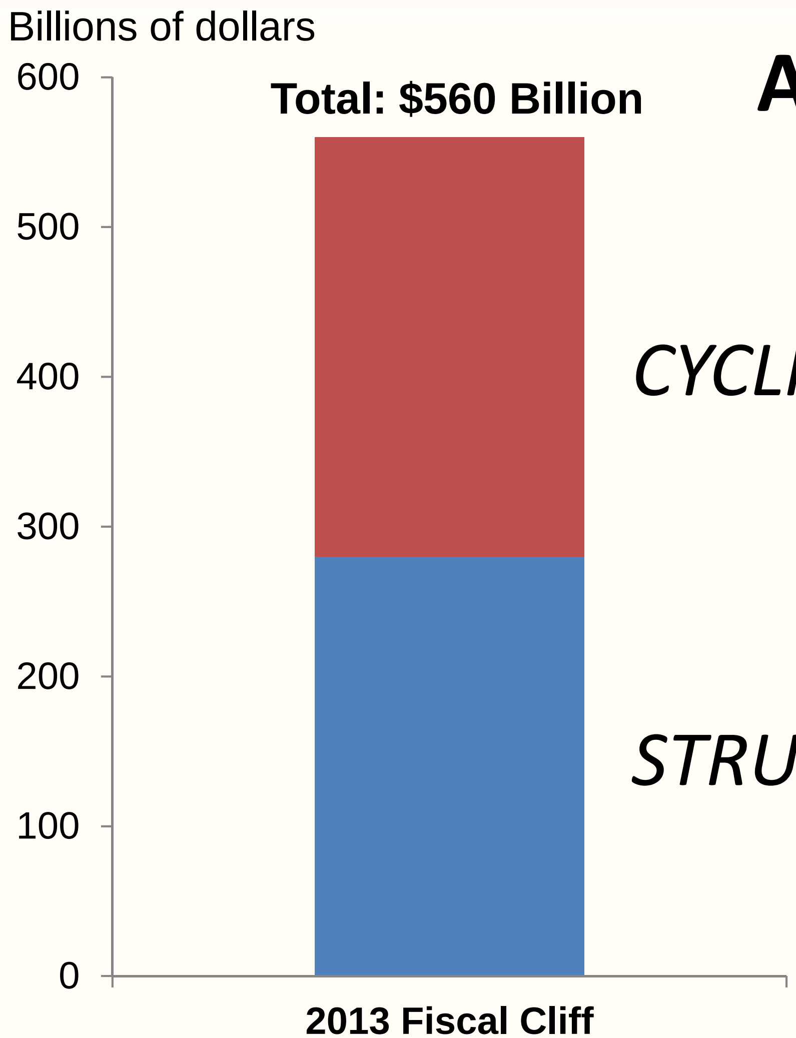
Federal Reserve Bank of Dallas

Real GDP Per Capita Still Below Peak



NOTE: The grey area indicates the range of the major recessions since 1960, excluding the short 1980 recession.

The 2013 Fiscal Cliff



An unusually large part of the Cliff is cyclical

CYCLICAL (maybe half)

STRUCTURAL (maybe half)

Cost of 2007–2009 Financial Crisis

- Between $10-20 trillion
- $, does not include misery and reduced opportunity
- Adverse impacts will likely endure for a long time
- Reduced capacity to respond to the next crisis
  - Insurance "is a system whereby a person who can't pay, gets another person who can't pay, to guarantee that he can pay."

— Charles Dickens, *Little Dorritt*

Choosing the Road to Prosperity:
Why We Must End Too Big to Fail – Now

Dallas Fed 2011 Annual Report

Complete Annual Report issue and presentation may be found at:
http://www.dallasfed.org/fed/annual/index.cfm

Dallas Fed 2011 Annual Report Follow-Up

OPINION | Updated April 4, 2012, 12:23 p.m. ET

THE WALL STREET JOURNAL.

How Huge Banks Threaten the Economy

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By RICHARD W. FISHER AND HARVEY ROSENBLUM

Our nation is at a fork in the road and the destiny of our financial system depends critically on choosing the correct route. One path leads to a continuation of the status quo, where some financial institutions are ordained by government policy to be "too big to fail" (TBTF) and where the rules of market capitalism are undermined and subverted. The other—the path to long-term prosperity—is the one we'll be on when we truly end TBTF.

“Though it sounds radical, restructuring is a far less drastic solution than quasi-nationalization, as happened in 2008-09.”

Too Big to Fail

A couple of working definitions:

- **TBTF = exempt from bankruptcy**
- **Bank resolutions are separate from bankruptcy court**
  - **But *not* TBTF if FDIC "in on Friday, out by Monday"**
- **"A financial institution so large, interconnected, and/or complex that its demise could substantially damage the financial system and economy if it were allowed to fail"**

TBTF: The Way Forward

- **Putting "market discipline" back into *market capitalism***
- **Clearly delineating the boundaries of the federal safety net to drastically reduce *moral hazard***
- **Maintaining the status quo with regards to TBTF guarantees another crisis (soon)**
- **Dodd-Frank (DFA) imposes regulatory checklists while maintaining perverse incentives and reduced competition**
    - ✓ ***CONCLUSION: A better way to end TBTF*—allow market forces to dominate restructuring of financial services and reduce reliance on DFA**

Three Pillars

Third Pillar: Market Discipline

Market discipline—Market-based forces that restrain a firm's stakeholders (stockholders, creditors, and management) from excessive risk-taking due to the belief that they are exposed to sharing the firm's losses.

Market discipline has been eroded by:

- Lack of analysis, understanding and skin-in-the-game
  - — Failures of due diligence and personal responsibility
- Extensions of the federal safety net (implicit and explicit)
- Industry consolidation that perpetuates TBTF

Further, DFA does little to embellish or reinvigorate market discipline

Market Discipline Impacts Medium-Sized Banks, But Not Megabanks

Matrix: bank size v. impact of market discipline

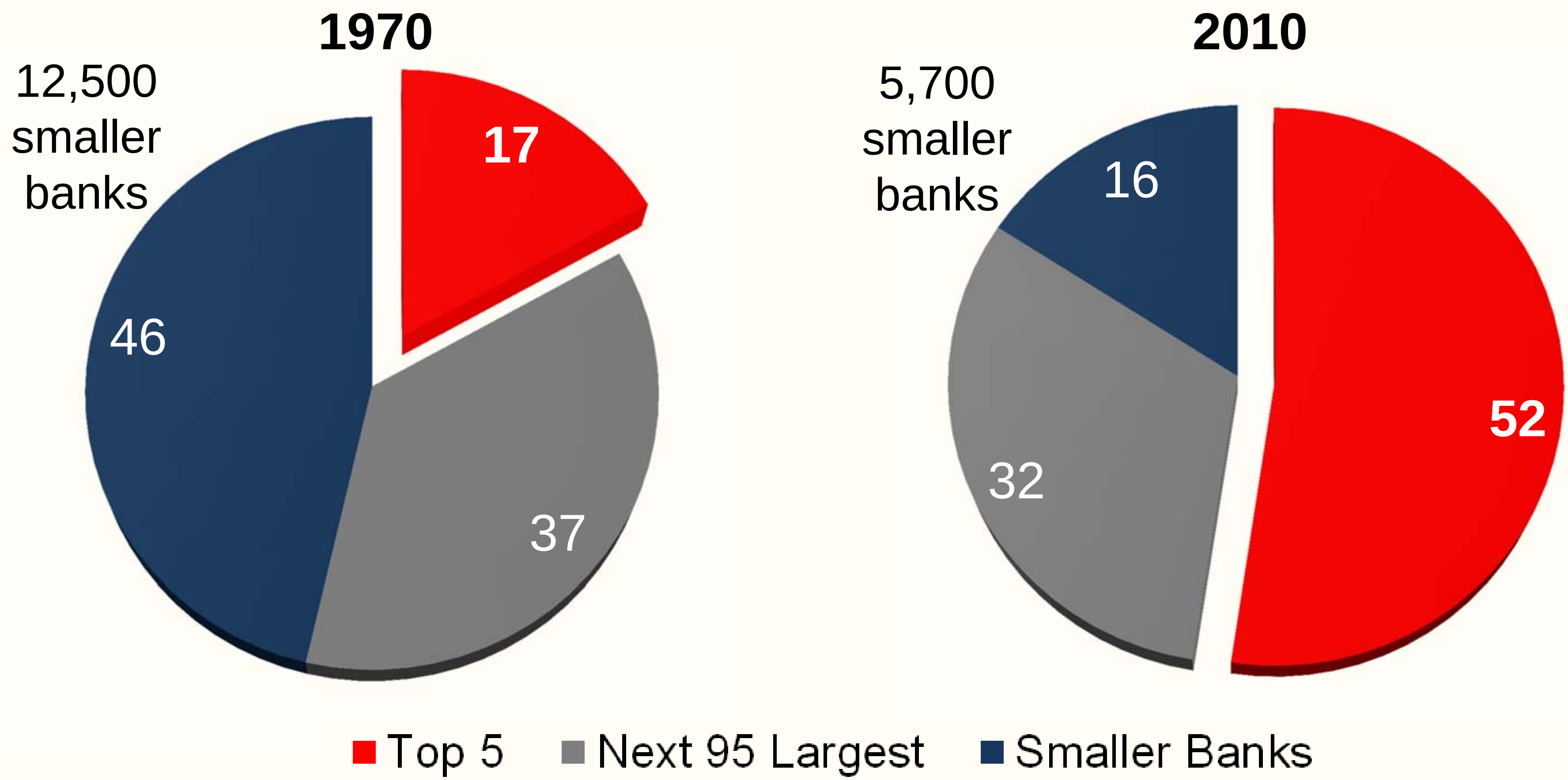
	Can Outright Fail?	Speed of Resolution	Market Discipline from Shareholders	MD from Unsecured Creditors
Community Banks	Yes	Weekend	Almost none	Too few to matter
Regional / Moderate-Sized Banks	Yes	Few weeks to 18 months	Some	Some, possibly significant
Megabanks	No	Never closed	Limited	Perverse

– **Banks need to be small enough for market discipline**

– **Market discipline is confined to the regional and moderate-size banks**

Big Banks Have Gained Market Share

Share of total U.S. banking industry consolidated assets



SOURCES: Federal Financial Institutions Examination Council, Reports of Condition and Income; Federal Reserve.

Bank Failure Resolution

Three-Way Classification System

1. In on Friday, out on Monday
2. Get in ASAP, out 2–18 months later
3. Can’t get in, can’t get out

TBTF: When You Can't Get In or Out

Measuring the impact of perceived official support on the creditworthiness of the largest U.S. BHCs in 2011

BIS 2012 Annual Report, p. 75–6:

- ✓ **Credit rating enhancement of more than 2 notches — From less than *A–* to just over *A+***
- ✓ **Lowers funding costs by about 100 basis points (1%)**
- ✓ **In spite of DFA's preamble stating its purpose to "end too big to fail"**

TBTF: Unfair Implicit Subsidies

Andrew Haldane, "On Being the Right Size," Oct. 25, 2012:

- ✓ **Haldane estimates credit rating enhancement of more than 3 notches, or up to $700 billion subsidy, in 2009**
- ✓ **Currently, the implicit subsidy is approx. $300bn per yr**
- ✓ **The 2002–07 average subsidy was $70 bn per yr**
- ✓ **Current proposals for systemic surcharges, resolution regimes, and structural reforms likely not sufficient**
- ✓ **Ending TBTF necessitates downsizing largest banks**

Note: All U.S. BHCs reported aggregate 2011 earnings of $108bn

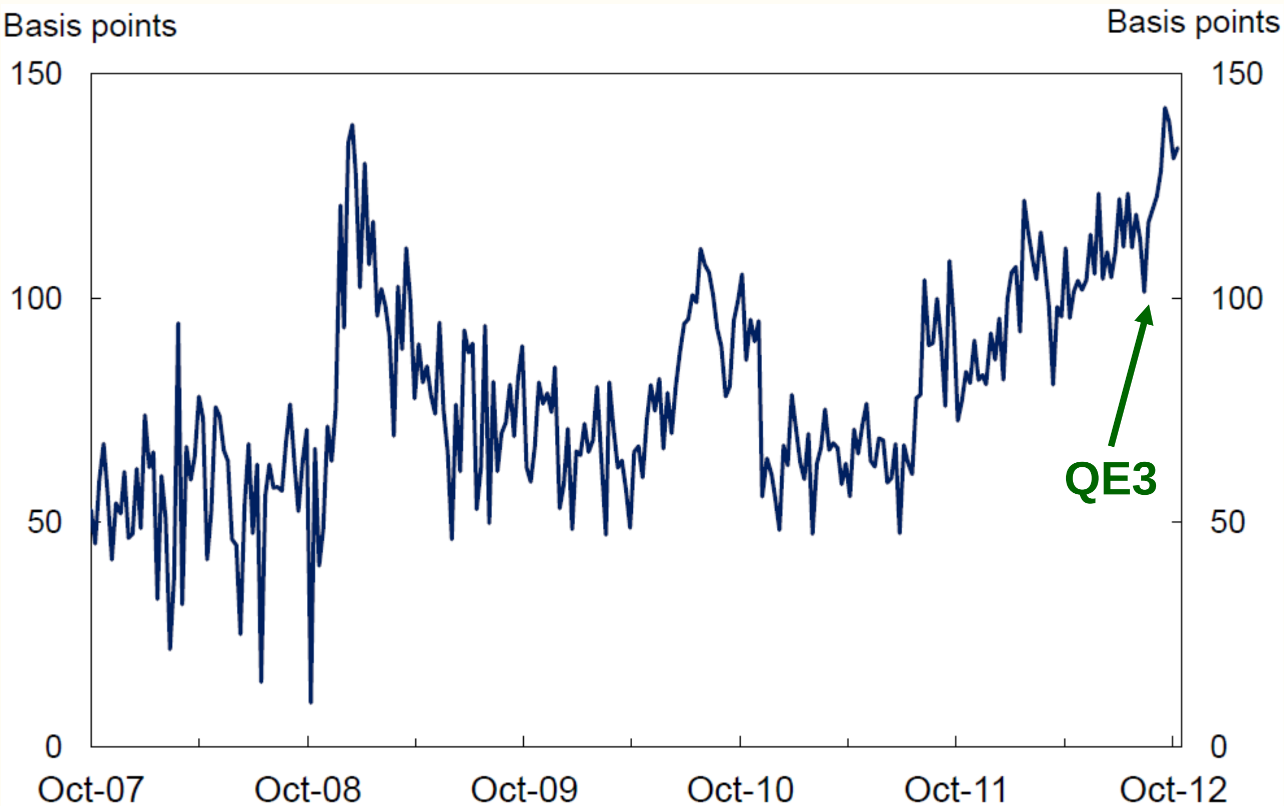
Three Perspectives of TBTF

Let me sum up:

1. **TBTF banks operate with limited market discipline**
2. **TBTF banks are gaining market share quickly**
3. **TBTF banks are subsidized to take excessive risks**

Additionally, Big Banks Block Transmission of Monetary Policy

30-yr Primary/Secondary Fixed Rate Mortgage Spread



- Although the spread between agency MBS and Treasury yields has narrowed, the **spread** between **mortgage rates** and **MBS yields** has ***increased***
- A few **big banks dominate** the mortgage industry, hampering competition and **restricting pass-through effects** from MBS to mortgages

SOURCES: Freddie Mac; Barclays; "The Recovery and Monetary Policy," Bill Dudley, NY Fed President, NABE Annual Meeting, Oct. 15, 2012.

What If We Maintain the Status Quo?

Time-travel forward…

- ✓ Don't address TBTF and we very well could see the Big 5 BHCs (52% of U.S. industry assets) become the Big 2 (~65%?)… then perhaps just the "Big One" that would be the single dominant banking institution
  - — Another crisis would be costly and could prompt this sort of consolidation
- ✓ Any time there are cost advantages you will see more of the subsidized activity

Can financial sector resiliency be repaired or improved?

(a.k.a., "*So what do we do about it?*")

No easy solutions,

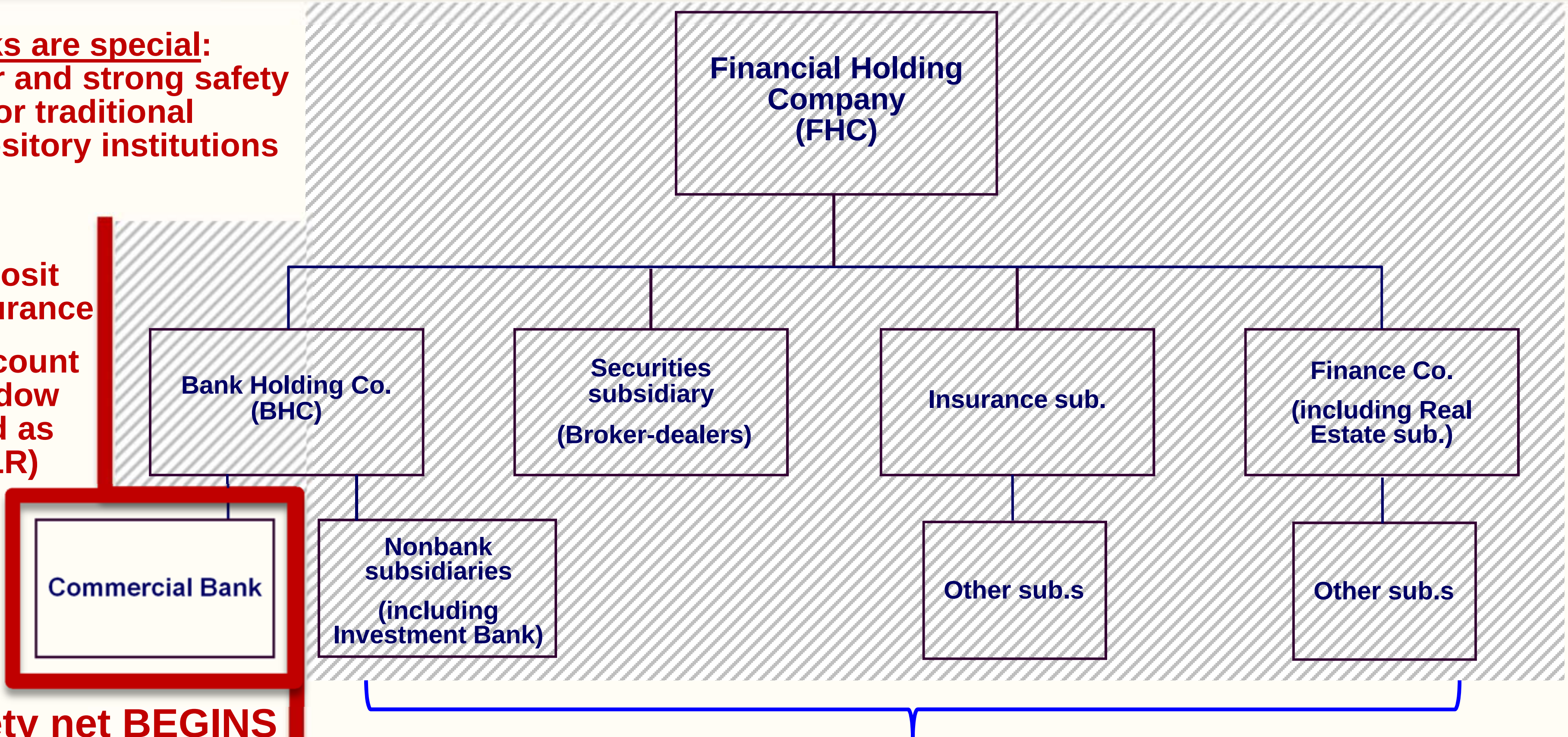
No good ones,

Need to <u>choose the *least worst*</u>

Clearly Define Where the Safety Net Begins and Ends

<u>Banks are special</u>:
Clear and strong safety net for traditional depository institutions

- ✓ Deposit insurance
- ✓ Discount window (Fed as LOLR)



Safety net BEGINS and ENDS <u>here</u>!

- ❖ Safety net DOES NOT cover these companies/subsidiaries
- ❖ There is NO GOV'T SUBSIDY: NONE. Counterparties should know this with certainty
- ❖ Creditors and counterparties should sign a disclosure that acknowledges this

Can We Get the Toothpaste Back in the Tube?

Safety net should be restricted to commercial banks

Costs and Benefits of Maintaining TBTF Status Quo

Costs

- Trillions to taxpayers and competitors*
- Next financial crisis will be bigger than the last one, and will happen sooner if TBTF policy remains
- Destruction of principles of capitalism which incent U.S. economy

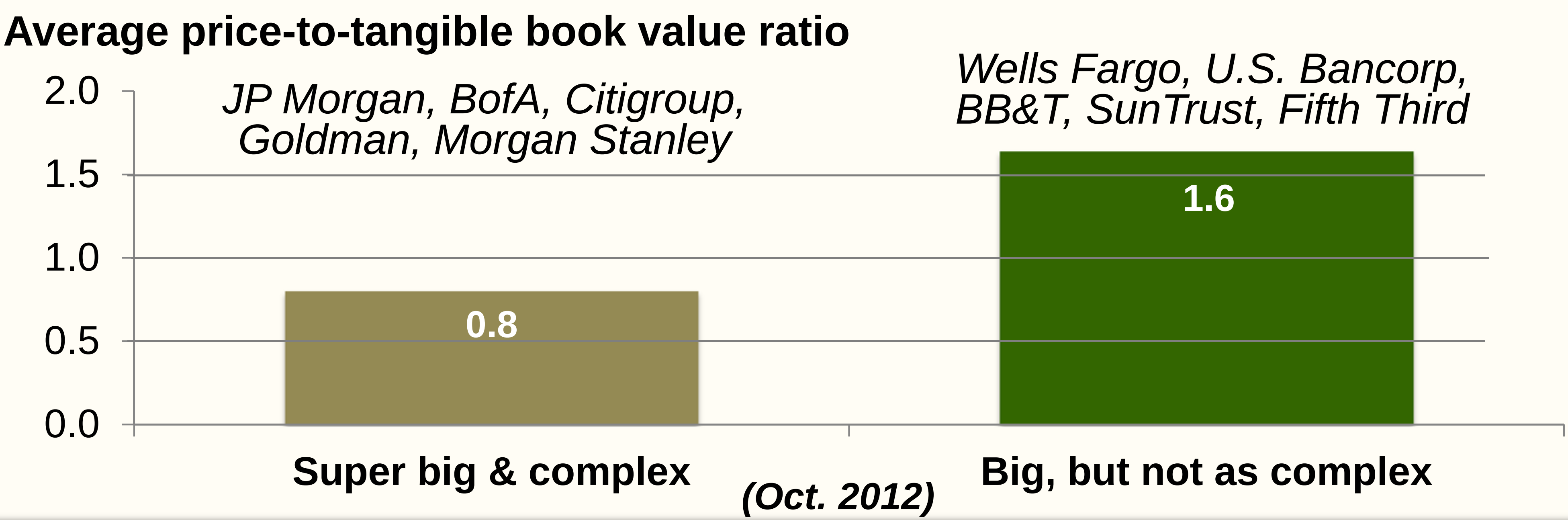
*** Trumps all benefits**

Benefits

- Maintain full range of financial services from universal banks
  - — Customer convenience
  - — Reduced need to deal with giant foreign banks
- Retain economies of scale and scope (if they exceed the diseconomies of dysfunctionality and TBTF subsidies)
- No need to unscramble the scrambled eggs of past mergers
- Bad regulation, not TBTF banks, caused the crisis, so trust DFA to get it right.

Reinforce the Market

- These recommendations are not actually that radical!
- The market is already moving this direction – Rewarding reduced complexity



SOURCES: Bloomberg; authors' calculations.

The TBTF Debate

Caps on the size of megabanks are being discussed…

Fed Governor **Daniel Tarullo**, *Penn Law School, Distinguished Jurist Lecture*: *http://www.federalreserve.gov/newsevents/speech/tarullo20121010a.htm*

- **Limit a bank's non-deposit liabilities to a set percentage of U.S. GDP**

  — Congress should legislate on the subject of TBTF due to the need to balance different interests and social goals

Virtues:

- **Simple**
- **Ties growth of financial firms to growth of the economy**
- **Avoids DFA's potentially shifting concentration limit of 10% of aggregate liabilities of "all financial companies"**

How Big is "Too Big"?

<u>Bank data and calculations as of second quarter 2012</u>

	Total Non-Deposit Liabilities ($B)	Non-Deposit Liabilities as a % of GDP	Total Subsidiaries	Countries of Operation
JP Morgan	*$983*	***6.3%***	*5,183*	*72*
B of A	*890*	***5.7***	*4,647*	*56*
Goldman Sachs	*817*	***5.2***	*3,550*	*53*
Citigroup	*816*	***5.2***	*3,556*	*93*
Morgan Stanley	*609*	***3.9***	*2,718*	*64*
Wells Fargo	*258*	***1.7***		
Bank of NY Mellon	*74*	***0.5***		
U.S. Bancorp	*73*	***0.5***		
PNC Financial	*52*	***0.3***		

*** According to Lehman Brother's 2007 annual 10-K filing, the firm had <u>209</u> registered subsidiaries in <u>21</u> countries.**

SOURCES: "Which Banks Could Face Cap on Size?" by Victoria McGrane, *WSJ* 10/11/12; Financial Stability Oversight Council 2012 Annual Report, p. 141.

The "Break-Up" Plan: Repairing the Pillars

Right-size the megabanks:

- ✓ Reintroduce market forces instead of complex rules
- ✓ Simplicity and clarity in how there are no government safety nets outside of regulated commercial banking
- ✓ The services provided by the re-sized and refocused megabanks will still be provided, but by unsubsidized financial companies.

Puts *DISCIPLINE* back in MARKET DISCIPLINE, and *MARKET DISCIPLINE* back in MARKET CAPITALISM

REMINDER: Why Is This Necessary?

We *must* end TBTF in order to:

- ✓ Rebuild the appropriate pillars for a resilient financial system
  - — Reinvigorate market discipline
  - — Level the playing field; all play by the same rules
- ✓ Remove/reduce taxpayer burden of the next crisis
- ✓ Change the "Bailout" vs. "End-of-the-world" decision-making paradigm
- ✓ Unblock the road to economic expansion and unclog the transmission gears of monetary policy

Conclusion

- We have accidentally stumbled into a place we never wanted to be
- We need to figure out a way to reverse course
- We have to find the passage back to the place we were before BUT we must ignore:

  "Relax said the night man
  We are programmed to receive
  You can checkout anytime you like
  But you can never leave!"

  - Don Felder, Don Henley, and Glenn Frey, ***Hotel California***

- Restoring market discipline is the key to finding that passage