Q&A with Richard Fisher on TBTF

Federal Reserve Bank of Dallas President Richard Fisher answers questions that have arisen about the Dallas Fed's proposal on ending "too big to fail."

Q. What is the Dallas Fed's proposal on addressing the issue of "too big to fail" (TBTF)?

Ours is a three-step approach: One, roll back the safety net to apply only to commercial banks and not to nonbank affiliates. Two, noncommercial bank customers and counterparties would sign a disclosure acknowledging there is no implied government backstop. Three, TBTF firms may need to be downsized and restructured, using as little public policy intervention as possible, to realign incentives and reestablish a competitive, level playing field.

Q. Why can't Dodd–Frank solve the TBTF problem?

Rather than resolve TBTF, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) essentially codified these mega-institutions' existence by designating some as "systemically important" and separating them from other banks. Moreover, the act's 849 pages and more than 9,000 pages of proposed regulations all but guarantee that authorities remain two or three steps behind the industry. Even the seemingly straightforward "Volcker Rule"—restricting banks' proprietary trading for their own accounts—gave rise to a nearly 130-page proposed rule with 383 questions for comment. Excessively complicated regulation only adds to the uncertainty that bedevils investors and business.

Dodd–Frank puts smaller institutions, which have fewer resources to devote to the new law, at a competitive disadvantage relative to their largest counterparts. If another crisis occurs, given current regulations, additional industry consolidation would lead to even larger banking behemoths.

Q. Doesn't Dodd–Frank provide procedures for dealing with big bank failures?

The "orderly liquidation authority" outlined in the act mandates that the Federal Deposit Insurance Corp. (FDIC) wind down large firms "that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." Dodd–Frank also instructs the FDIC, when disposing of assets, to act "to the greatest extent practicable" in a manner that "mitigates the potential for serious adverse effects to the financial system." That leaves significant wiggle room for perpetuating TBTF. To avoid "end-of-the-world" decisionmaking, the bailout paradigm of the last crisis would remain intact.

Q. Apart from Dodd–Frank, large banks have bolstered capital and liquidity while improving risk controls. Aren't institutions stronger now?

These changes are what we would hope to see develop as best practices. However, they fall short of removing the TBTF subsidy that remains for the largest, most complex banking organizations. Until all financial firms are considered "too small to save," and the playing field is leveled, the big banks will remain comparatively less influenced by regulatory and market discipline.

Q. Wouldn't breaking up the big banks harm the still-fragile economy?

While there may be *some* economic benefits to size and scope, numerous studies suggest that the benefits of size are limited. In fact, simple logic would dictate that if you are "too big to fail," you're also "too big to manage." If a large multinational corporation needs a huge bridge loan to close a deal or expand services, a group of lenders could share the risk. From lending data, we know that smaller banks serve the smaller businesses that drive job growth. A healthy and competitive banking model that serves the needs of job creators will help get the economy back on the path to stronger growth.

Restructured, refocused and *unsubsidized* financial conglomerates will still provide a full range of financial services. They will operate with a clarified understanding of the boundaries of FDIC protection and access to the Federal Reserve's discount window—only traditional commercial banking operations should benefit from the safety net.

(Continued from Q&A with Richard Fisher on TBTF)

Q. Won't breaking up the TBTF banks be significantly disruptive and/or prohibitively costly?

It could be both disruptive and costly, but *doing nothing* will be even costlier, as we saw during the financial crisis. Do we want to go through that again, this time with an even more concentrated and entrenched banking industry shielded by Dodd–Frank? *That* would be significantly more disruptive and prohibitively costly.

Q. Why should government interfere in private sector, banking industry decisionmaking?

Government policy permitted banks to become too big and subsidized size at the expense of efficiency, so any new policy needs to correct this blunder by setting the playing field level once again. Public safety nets temper runs on bank deposits and promote the safety and soundness of the payments system. These social benefits come with social costs—the need for regulatory oversight of the banking industry.

Q. Have you considered other alternatives, such as allowing large banks to operate almost as regulated utilities, with tough new requirements, as Europe is considering?

There is no reason banks should be utilities, with very limited competition and very difficult entry, which is essentially where policy is headed in Europe. While we respect European policymakers in many respects, we don't think we should emulate that trend.

To use an economic term, banks are not a "natural monopoly." Let them be subject to free and fair competition, just like in other industries, with both the freedom to make money and the freedom to fail. U.S. taxpayers have agreed to spend the money needed to ensure the safety and soundness of our collective payments system, but not to backstop the handful of TBTF institutions seeking an exemption from failure.

Q. How can the community banking model become more vibrant when it is hindered by the Fed's "zero-bound" interest-rate policy and Dodd–Frank?

Fed policy decisions and Dodd–Frank regulations may be challenges, but they are, in part, the product of issues stemming from TBTF that directly threaten the community banking model. Shrinking net interest margin is a consequence of a banking system hijacked by TBTF. If the normal rules of capitalism applied to the financial sector, community banks could gain market share if a TBTF bank failed. The problem is they aren't allowed to fail.

Fiscal transfers, regulatory forbearance and extremely accommodative monetary policy have worked to buttress the behemoth banks at the expense of nearly everyone else. Given the policies in place during the crisis, it has been argued that such intervention was the best effort and option to save the financial system. Now, during the recovery and reform period, it is imperative that we put better policies in place to avoid such a dire outcome in the next crisis.

Q. The Dallas Fed's favored community bank model resembles the one in place during Texas' banking collapse in the 1980s, when banks were too close to customers. Aren't you exchanging one set of regulatory issues for another?

The '80s collapse, while it cannot be taken lightly, was resolved better than our most recent crisis. Weak Texas banks were allowed to fail, and other banks filled the void—although, admittedly, some of those rescuers were on the path to becoming TBTF. These failures left a mark on the Texas banking industry; avoiding their repetition is one of many reasons why Texas has outperformed the nation during the recovery. We doubt the TBTF banks, not subject to true market discipline, have learned many enduring lessons from the most recent crisis.

Q. How appropriate is a community bank model in an age of globalization and far-flung financial intermediaries?

"Community bank" isn't the same thing as "tiny bank." There are banks well below TBTF size that operate internationally, and if American corporations require certain global services, the marketplace will provide them.

Q. Doesn't an economy as large and diverse as ours need financial institutions of all sizes, with diverse business models and strategies?

Yes, the flexible, highly diverse economic engine of growth that is the United States needs a credit intermediation system (taking in short-term deposits and lending longer-term) that supports such vitality. However, our country has become robustly dynamic upon the currents of creative destruction—a "reap what you sow," free-market process of success and failure, innovation and obsolescence. Viable business models should be given the opportunity to compete and prosper on their own merits, while unattractive strategies should be allowed to fail. Subverting the ability to fail, on the taxpayers' dime, is a perversion of American capitalism.

Q. How do TBTF banks affect monetary policy?

In a September 2009 *Wall Street Journal* article, we called TBTF "the blob that ate monetary policy." When they experience stress, TBTF banks gum up the usual channels of monetary policy, so it must be looser than it would be otherwise to get the same amount of stimulus to the economy. An analogy we like to use involves an automobile engine: If there is sludge on the crankshaft—in the form of losses and bad loans on the balance sheets of the TBTF banks—then the bank-capital linkage that greases the engine of monetary policy does not function properly to drive the real economy. No amount of liquidity provided by the Federal Reserve will help power growth if this transmission mechanism is broken.

Q. How would the Dallas Fed proposal prevent banks' use of so-called off-balance-sheet vehicles that can conceal institutional health?

Depository institutions should have everything on their balance sheets so investors can appropriately gauge operations. Special-purpose vehicles and off-balance-sheet financing—forms of shadow banking—should occur in a separately funded, collateralized subsidiary without a federal safety net. Nontraditional banking and intermediation should be clearly separated so that there is no implicit subsidy. Any transaction with the holding company or shadow bank affiliates should be at arm's length from the commercial banking institution. Under our proposal, customers and counterparties of nontraditional banks would sign a disclosure acknowledging there is no implied government backstop, notably via the Fed's discount window and federal deposit insurance. Those would only be available for the commercial banking arm. With proper transparency, the equity and debt providers will consider appropriate risks, funding costs will adjust and market discipline will help rein in excesses.

Q. How should bank regulators deal with nonbank financial firms, such as GE and AIG, who were closely watched during the crisis?

That's a good question to ask the new Financial Stability Oversight Council, established under Dodd–Frank and charged with identifying threats to national financial stability. Dodd–Frank also makes provisions for corporate entities with extraordinary financial system presence, designating them as "systemically important." They will come under the Federal Reserve's supervision. When regulators designate a firm as systemically important, they signal that they are TBTF.

AIG is an interesting case. The company's restructuring and exit from quasi-nationalized status after its rescue have been in the news recently. How did the company experience a turnaround from insolvency to profitability? According to Francesco Guerrera of the *Wall Street Journal* , AIG was *massively downsized* and made a *simpler*, *more manageable* company.

Q. How do the Basel III international banking requirements governing liquidity, capital ratios and eligible collateral impact TBTF?

The liquidity rules would little affect TBTF. Regulators must achieve a delicate balance between regulation and growth. Too much regulation can stifle growth; so can too little or ineffective regulation, as evidenced by the financial crisis. U.S. banking regulators haven't yet introduced their liquidity proposals and are considering thousands of comments submitted. Besides, the robustness of the new Basel liquidity rules is debatable. In our view, the Basel committee softened the rules initially proposed, although Mervyn King, the governor of the Bank of England, says they are neither weaker nor stronger, just more "realistic."

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Q. Capping bank size has been discussed by the Dallas Fed and others. How big is too big?

Ideally, that question would be determined by market forces. As we've noted in this report ("Leveling the Playing Field"), the stock market seems to be penalizing large, complex banking organizations with lower relative valuations. The Dallas Fed wants to impart community bank virtues—relationship-based, conservative lending influenced by regulatory and market discipline—to the core of the banking system as a whole. We could attempt to remove implicit TBTF subsidies through a taxation scheme, or realign incentives through legislation or regulation, and then see where it leads us. But this would replace market forces with increased regulation and politically influenced bureaucracy.

Unfortunately, a subsidy once given is nearly impossible to take away. Overcoming entrenched oligopoly forces, in combination with customer inertia, may require government-sanctioned reorganization and restructuring of the TBTF firms in order to accelerate the imposition of effective market discipline. We advocate using as little government intervention and statutory modification as possible to restructure the largest institutions to a size that is effectively disciplined by both market and regulatory forces—so that every corporate entity is subject to a speedy bankruptcy process, and every banking entity is "too small to save." This would underscore to customers and creditors that a credible regime shift has taken place, and the reign of TBTF policies would end.