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

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The views expressed are those of the authors and not necessarily those of others in the Federal Reserve System.
Real GDP Per Capita Still Below Peak

At this pace of growth, it will still be at least another year until households regain their prior level of income (late 2013 / early 2014).

NOTE: The grey area indicates the range of the major recessions since 1960, excluding the short 1980 recession.
The 2013 Fiscal Cliff

Total: $560 Billion

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 Dorrit
“Though it sounds radical, restructuring is a far less drastic solution than quasi-nationalization, as happened in 2008-09.”
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”
- 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
Without strong market discipline, this financial edifice collapses.
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
## Matrix: bank size v. impact of market discipline

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

- 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

1970
- Top 5: 37%
- Next 95 Largest: 46%
- Smaller Banks: 17%

2010
- Top 5: 52%
- Next 95 Largest: 32%
- Smaller Banks: 16%

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
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”

- 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

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.

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 choose the least worst
Clearly Define Where the Safety Net Begins and Ends

Banks are special: Clear and strong safety net for traditional depository institutions

Safety net BEGINS and ENDS here!

- Deposit insurance
- Discount window (Fed as LOLR)

Financial Holding Company (FHC)

- Bank Holding Co. (BHC)
- Securities subsidiary (Broker-dealers)
- Insurance sub.
- Finance Co. (including Real Estate sub.)

Nonbank subsidiaries (including Investment Bank)

Other sub.s

Other sub.s

- Commercial Bank

- Other sub.s

Safety net DOES NOT cover these companies/subsidiaries

There is NO GOVT 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

**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.

* Trumps all benefits
Reinforce the Market

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

Average price-to-tangible book value ratio

<table>
<thead>
<tr>
<th>Category</th>
<th>Ratio (Oct. 2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Super big &amp; complex</td>
<td>0.8</td>
</tr>
<tr>
<td>Big, but not as complex</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Sources: Bloomberg; authors’ calculations.
The TBTF Debate

Caps on the size of megabanks are being discussed...


- 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”?

## Bank data and calculations as of second quarter 2012

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

* According to Lehman Brother's 2007 annual 10-K filing, the firm had 209 registered subsidiaries in 21 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**
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
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