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Too Big to Fail: Motives, Countermeasures, and the Dodd-Frank Response

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ABSTRACT

Government forbearance, support, and bailouts of banks and other financial institutions deemed "too big to fail" (TBTF) are widely recognized as encouraging large companies to take excessive risk, placing smaller ones at a competitive disadvantage and influencing banks in general to grow inefficiently to a "protected" size and complexity. During periods of financial stress, with bailouts under way, government officials have promised "never again." During periods of financial stability and economic growth, they have sanctioned large-bank growth by merger and ignored the ongoing competitive imbalance.

Repeated efforts to do away with TBTF practices over the last several decades have been unsuccessful. Congress has typically found the underlying problem to be inadequate regulation and/or supervision that has permitted important financial companies to undertake excessive risk. It has responded by strengthening regulation and supervision. Others have located the underlying problem in inadequate regulators, suggesting the need for modifying the incentives that motivate their behavior. A third explanation is that TBTF practices reflect the government's perception that large financial firms serve a public interest—they constitute a "national resource" to be preserved. In this case, a structural solution would be necessary. Breakups of the largest financial firms would distribute the "public interest" among a larger group than the handful that currently hold a disproportionate concentration of financial resources.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 constitutes the most recent effort to eliminate TBTF practices. Its principal focus is on the extension and augmentation of regulation and supervision, which it envisions as preventing excessive risk taking by large financial companies; Congress has again found the cause for TBTF practices in the inadequacy of regulation and supervision. There is no indication that Congress has given any credence to the contention that regulatory motivations have been at fault. Finally, Dodd-Frank eschews a structural solution, leaving the largest financial companies intact and bank regulatory agencies still with extensive discretion in passing on large bank mergers. As a result, the elimination of TBTF will remain problematic for years to come.

Keywords: Too Big to Fail; Banking Policy; Antitrust; Government Policy; Regulation

JEL Classifications: G21, G28

I. INTRODUCTION

Government policies to forbear, support, and bail out banks and other financial companies deemed too big to fail (TBTF) are now widely recognized as raising several critical issues: (1) a moral hazard issue that encourages large banks to take excessive risk; (2) a competitive issue that puts smaller banks at a competitive disadvantage; and (3) a behavioral issue that encourages banks to grow inefficiently to a "protected" size and complexity. During periods of financial stress, government officials have promised "never again." During periods of economic prosperity, they have sanctioned large bank growth by merger and ignored the ongoing competitive imbalance.

The inability over many years to do away with TBTF practices suggests that its etiology has not been fully understood. In my working paper for the Levy Institute, I considered several explanations for its survival, and the countermeasures they implied.[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 constitutes the most recent effort to eliminate TBTF. My review suggests that it is unlikely to achieve its objective.

II. THE TBTF PROBLEM IN PERSPECTIVE

Financial institutions deemed TBTF are not a recent phenomenon. Looking back, one can find evidence of such protection from the very early days of modern banking. In the United States, however, the modern version of the problem developed about 30 years ago with the failure of Continental Illinois of Chicago—at the time, one of the largest banks in the country. Out of an expression of concern for the systemic impact, the Comptroller of the Currency announced that the largest banks in the United States, including Continental, were too big to fail; and the FDIC, supported by the Federal Reserve, announced protection for all its creditors and those of its affiliates. Through the remainder of the 1980s and into the 1990s, creditors of both failed savings and loan associations and large commercial banks were also afforded government protection.

In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and in 1991, the FDIC Improvement Act (FDICIA) aimed at the elimination of TBTF. Both

[1] Shull, Bernard. 2010. "Too Big to Fail in Financial Crisis: Motives, Mergers and Countermeasures." Working Paper No. 601, Annandale-on-Hudson, NY: Levy Economics Institute of Bard College.

provided more stringent regulation and supervision, including increased capital requirements. FDICIA constrained FDIC and Federal Reserve discretion in supporting uninsured creditors of failing banks. It also established a new procedure, termed "prompt corrective action," that was intended to close banks before their capital was extinguished. FDICIA, nevertheless, included a "systemic risk exemption," applicable to large banks. It was expected, however, to be rarely exercised, and required a joint determination by the FDIC, the Federal Reserve, and the Secretary of the Treasury (with agreement by the President).

These constraints appeared to make a continuation of TBTF practices at the least, uncertain—a condition that some celebrated as "constructive ambiguity." However, between the early 1990s and the financial crisis of 2008, the persistence of favorable funding costs for very large banks, as well as Federal Reserve behavior, strongly suggested that TBTF was alive and well. The Fed's organization of a bailout for Long-Term Capital Management in 1998, out of concerns for large banks to which the hedge fund was indebted, provided evidence. Experience in the recent financial crisis eliminated all doubt.

III. REASONS FOR RESISTANCE AND REMEDIES

Conventional wisdom says that the roots of TBTF lie in inadequate regulation and supervision, with the result that large banks take on excessive risk; and, in their imminent failure, bailouts become an imperative. Bailouts are justified, as Alan Greenspan suggested with respect to the Long-Term Capital Management episode, on the grounds that the impact on moral hazard is more than offset by the disaster in financial markets that would occur if the hedge fund had been forced into sudden bankruptcy; see Lowenstein (2000) and GAO/GGD (1999). The conventional remedy for preventing bailouts, then, is better regulation and supervision.

There is a question, nevertheless, as to whether regulators tend to exaggerate systemic threats. A post-bailout analysis of Continental Illinois found that closing the bank without protection for uninsured creditors would not have resulted in the failure of many other banks. There was little empirical evidence that substantial system-wide damage would have occurred if Long-Term Capital Management had not been bailed out; see Stern and Feldman (2004). However, even if regulators perceive a low probability of substantial systemic damage prior to a bailout, they may still conclude that the expected cost of doing nothing is high.

In any event, the claim of exaggeration conforms to the view that the persistence of TBTF practices is not due to inadequate regulation, but to the frailty, if not malevolence, of the regulators. It has been contended that, out of concern for their careers, they have covered up large-bank problems, have been sluggish in closing banks when insolvent, and much too quick to bail them out.[2] It is a small step to link such behavior to complaints about the political influence of large financial institutions.

If the roots of TBTF lie in perverse regulatory behavior, then reforms are needed to alter incentives and, possibly, the entire regulatory culture. One author has suggested a publicly funded West Point for financial regulators who, at higher salaries, would be willing to "embrace the fiduciary duties their agency owes to society..." (Kane 2010b).

Finally, TBTF practices can also be attributed to the high value the government places on the survival of the largest banks. In countries where large banks are critical to the allocation of resources, the relationship is apparent. Without central planning or industrial policy, and with well developed capital markets, this cause may not seem important in the United States.

There is, nevertheless, a long history of interdependence in the bank-government relationship. In the *Hearings* on Continental Illinois, Congressman Jim Leach asked the Comptroller of the Currency, C. T. Conover, whether one could not argue for the bailout "on size grounds... to save something that is truly important, *a national resource*" (Leach 1984, p. 373 [italics added]).[3] Congressman Frank Annunzio defended the bailout by citing that "...10,000 or 12,000 Continental employees would have lost their jobs, as well as the employees of the other banks who had large uninsured deposits" (Annunzio 1984, pp. 80, 81). The "national resource" rationale is, in fact, the only one that would also account for bailouts of nonfinancial firms, such as Chrysler and General Motors.

If, in fact, a "national resource" rationale underlies the persistence of TBTF, better supervision and regulation might or might not help, but more dedicated regulators would be irrelevant. Bailouts would reflect a regulatory dedication to government purposes. The remedy, rather, would lie in structural deconcentration to diversify the national interest among a large

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[2] Edward Kane has been the principal proponent of this view. For a recent expression of this argument, see Kane (2010a); (2010b).

[3] The Comptroller replied: "No, we never thought Continental was important as a national resource." It is not clear from the record that Leach accepted this answer.

enough group of financial companies such that the failure of any one or few would not be seen as critical.

Unfortunately, bank merger policy over the last several decades has promoted concentration and facilitated the growth of a handful of mega-banks that now dominate the financial system. (An Appendix to my aforementioned Levy working paper presents the lineage of the largest banks through merger, and reviews the merger policy that facilitated their growth). If the largest banking companies had achieved their current size because of economies of scale and scope, a proposal to deconcentrate would suggest the need to balance costs and benefits. But after decades of economic research, a consensus has emerged to the effect that economies of scale are exhausted at well below the size of the largest banks, and economies of scope are difficult to find. At most, one can say that available techniques for investigating large-bank economies are inadequate, in part because of their fewness, and in part because it is not possible to separate the advantages of scale and scope from those of being too big to fail.[4]

IV. THE DODD-FRANK RESPONSE

The Dodd-Frank Act is the latest in a series of legislative efforts to exorcize TBTF. It formally forbids future bailouts and proscribes all practices that would generate taxpayer losses.

To effect these prohibitions, it has, among other things, created a new Financial Stability Oversight Council (FSOC), chaired by the Treasury Department and composed of other federal agencies with financial sector responsibilities. The aim of the FSOC is to identify and monitor risks to the financial system and coordinate responses.

The Act designates all bank holding companies with over 50 billion dollars as systemically important financial institutions (SIFIs). The FSOC is responsible for establishing criteria for designating nonbank financial institutions as SIFIs. All SIFIs are to be supervised by the Federal Reserve, and subject to “enhanced prudential standards” including higher capital requirements and other balance sheet constraints related to the level of systemic risk they portend.

[4] For a recent review of the literature, see Scherer (2010). For a brief analysis of the issue, see, also, DeYoung (2010).

The Act requires SIFIs to develop credible resolution plans, so-called "living wills," that will permit their safe liquidation through bankruptcy. The FDIC and the Federal Reserve are authorized to require changes in the structure and activities of SIFIs, if needed, to establish credible plans. Companies that do not develop a credible plan are subject to serious penalties, including forced divestitures.[5] The alternative to bankruptcy, is the "orderly liquidation authority," provided by the FDIC. It can take a failed financial company into receivership so that it continues to function (e.g., as a "bridge bank") until sold; see Blair (2011).

In addition to more stringent supervision and regulation, Dodd-Frank includes some new restrictions on financial industry structure. First, it establishes a prohibition on mergers and acquisitions for financial companies (depository institutions, other Federal Reserve supervised nonbank financial companies, and foreign banks in the US) where the resulting firm's liabilities exceed 10 percent of the aggregate liabilities of all financial companies nationwide (Dodd-Frank Act, Sec. 622).[6] The previous 10 percent limit had applied only to banking companies and deposits of insured depository institutions (Riegle-Neal Banking Interstate Banking and Branching Efficiency Act of 1994, Title I, Sec. 101). The restricted coverage had invited circumvention by large banking companies through the acquisition of firms with non-deposit liabilities.

The Act also adds a new element to merger review. Before Dodd-Frank, the Federal Reserve, in passing on large mergers and acquisitions, considered competitive effects, based on antitrust standards, "the convenience and needs of the community," including conformity to the requirements of the Community Reinvestment Act and the financial/managerial condition of the resulting institution, including its "safety and soundness." Dodd-Frank requires that it now also "take into consideration the extent to which a proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system" (Dodd-Frank Act, Section 604 (d), (e), (f)). Thus, the Federal Reserve must now evaluate the systemic threat and, possibly, related competitive effects

[5] The Act constrains both Federal Reserve and FDIC support for failing companies; e.g., see Dodd-Frank Act, Title II, Sec. 1101.

[6] Liabilities are defined as "risk-weighted assets minus regulatory capital."

of combinations that create or increase the size of banking companies too big to fail—something it has never done before.[7]

V. PROSPECTS

The new law aggressively strengthens the regulation and supervision of large financial companies. It newly extends bank regulation to nonbanking companies, and is innovative in its "living will" requirement. The extension reflects the importance of large nonbank companies in the crisis of 2008-09. The "living will" seems a critical addition, but also raises significant questions.

In a recent talk, Sheila Blair, former chairperson of the FDIC, discussed the difficulties of safe resolution, given the complexity of large financial companies with hundreds or thousands of subsidiaries across national and global jurisdictions (Blair 2011). She observed that:

> Under the new...resolution framework, the FDIC should have a continuous presence at all designated SIFIs, working with the firms and reviewing their resolution plans as part of their normal course of business.... (ibid.)

But "safe resolution," will require more of the agencies than a "continuous presence."

> …[U]ltimate effectiveness will still depend on the willingness of the FDIC and the Federal Reserve...to require organizational changes that promote the ability to resolve SIFIs.... [They] must be willing to insist on organizational changes.... Unless these structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it needs to be. (ibid.)

Congress foreswore the opportunity to break up the large, failing financial companies during the crisis, but left it to the FDIC and the Federal Reserve to rationalize their organizational structure so that any future failures will not present a systemic threat. This delegation of authority is remarkable in its potential reach and raises a myriad of questions. It remains to be seen how the FDIC and the Federal Reserve deal with this new authority.

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[7] The Dodd-Frank Act also provides that financial holding companies, with assets of 50 billion dollars or more, must notify the Board before acquiring ownership or control of companies with 10 billion dollars or more in assets that are engaged in "permissible" nonbanking activities (Dodd-Frank Act, Sec 163 (b)(4)). The Federal Reserve must also consider whether these acquisitions would result in additional risk to financial stability.

Dodd-Frank does little to constrain the growth of large banking companies directly. The new 10 percent liability limit will not reduce the size of any of the largest financial companies, nor keep them from taking advantage of their existing dominance to grow further without merger.

The new "risk to stability" factor in merger review does not, it appears, preclude the approval of combinations that present a systemic threat. Governor Tarullo of the Federal Reserve recently pointed out that the potential systemic costs in such merger cases must be balanced against the "potential benefits from...a lesser likelihood of failure or...a greater capacity to...fill the gap if one of the ...large competitors were to fail" (Tarullo 2011a, pp. 5-6). [8] Increased competition for larger banks as a result of a merger and possible efficiency gains are also likely to be weighed against the potential systemic cost. The problematic nature of such balancing is obvious.

There is, nevertheless, an indirect measure in Dodd-Frank that may impact structure. Governor Tarullo has also suggested that the higher capital requirements for SIFIs (Dodd-Frank and Basel III) will tend to restrain large financial company growth. He suggests that they will "...offset any funding advantage SIFIs derive from their perceived status as too big to fail, and provide an incentive for such firms to reduce their systemic footprint..." (Tarullo 2011b). [9]

Finally, it is worth mentioning that Dodd-Frank does not give credence to complaints that bank regulators have not functioned in the public interest. To the contrary, it augments the authority of the existing agencies and their staff, supplemented by the new FSOC coalition, and depends for its success on their effective performance.

In summary, then, Dodd-Frank's promise to end TBTF principally relies on extending and strengthening regulation and supervision. The "living will" is new a element, but raises practical issues that will not be resolved easily. It is worth repeating that, up to now, earlier reforms have been unsuccessful. As long ago as the Continental Illinois bailout in 1984, Congressman Ferdinand St Germain expressed his frustration:

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[8] Two large merger cases now pending should throw additional light on how the Federal Reserve Board intends to implement the new systemic risk consideration: the Capital One acquisition of ING, and PNC acquisition of Royal Bank of Canada branches in the United States. Each would result in banks with about 300 billion dollars in assets. (Note: The Board approved the PNC acquisition in December 2011 and the Capital One acquisition in February 2012).

[9] Higher capital requirements would operate as a tax on size. For an early proposal to reform merger policy, including the need for higher capital requirements for large banks, see Shull and Hanweck(2001, pp. 190-97).

> [We] battled uphill ...to enact an entire set of new and improved supervisory powers—to make certain that no one in the Federal supervisory bureaucracy could claim they lacked the tools. Yet, today, we return to this forum...the granddaddy of bank failures...rolled into the ditch uncontrolled.... (St Germain 1984, p. 1)

There are reasons why regulation and supervision are limited in what they can accomplish, not the least being the impact of unanticipated shocks to bank solvency.[10] The failure of the new law to promote deconcentration directly, leaving the potential beneficiaries of TBTF policies as they were, will invariably raise questions. Much will depend, as it always has, on how the regulatory agencies exercise their extensive discretion, now amplified by Dodd-Frank. This is something that will not be known for years. Despite the Act's stated ban on TBTF, it has, to its discredit, failed to eliminate the misgivings that existed prior to the crisis of 2008-09.

VI. CONCLUSIONS

It is widely recognized that government support for large banking companies in danger of failing has harmful consequences. Repeated efforts to do away with TBTF practices over the last several decades have, however, been unsuccessful. This lack of success suggests that one or more factors of importance have not been addressed.

Traditionally, Congress has located the problem in inadequate regulation and has responded by strengthening it. Others have located the problem in inadequate regulators, suggesting the need for modifying the incentives they confront. A third explanation suggests that TBTF is symbolic of the value government places on the survival of large banks, viewed as a "national resource." The "national resource" explanation suggests the need for deconcentration.

Finding the principal root cause for TBTF in inadequate regulation and supervision, the Dodd-Frank Act extends and augments the authority of the regulatory agencies. It has, thus, taken an approach that, up to now, has never failed to fail. In doing little to eliminate the dominance of a handful of very large financial companies, it has left the critical element for bailouts in tact. Because much will depend on how the regulators exercise their discretion, the success of the law will, unfortunately, be problematic for years to come.

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[10] See, for example, Minsky (1972) and Shull (1993).

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