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Too-Big-to-Fail Too Hard to Fix Amid Calls to Curb Banks

By Craig Torres & Cheyenne Hopkins - Feb 4, 2013

Top U.S. bank regulators and lawmakers are pushing for action to limit the risk that the government again winds up financing the rescue of one or more of the nation's biggest financial institutions.

Officials leading the debate, including Federal Reserve Governor Daniel Tarullo, Dallas Fed President Richard Fisher and Senator Sherrod Brown, share the view that the 2010 Dodd-Frank Act failed to curb the growth of large banks after promising in its preamble to "end too big to fail."

Strategies under consideration range from legislation that would cap the size of big banks or make them raise more capital to regulatory actions to discourage mergers or require that financial firms hold specified levels of long-term debt to convert into equity in a failure.

The push for revisiting the law or writing new rules "is absolutely driven by a sense that Dodd-Frank did not end too big to fail," said Mark Calabria, director of financial-regulation studies at the Cato Institute in Washington and a former aide to Senator Richard Shelby of Alabama when he was the ranking Republican on the Banking Committee.

Three of the four largest U.S. banks -- JPMorgan Chase & Co. (JPM), Bank of America Corp. and Wells Fargo & Co. (WFC) -- are bigger today than they were in 2007, heightening the risk of economic damage if one gets into trouble. JPMorgan's 2012 trading loss of more than $6.2 billion from a bet on credit derivatives raised questions anew about whether the largest institutions have grown too complex for oversight.

Restructuring Megabanks

That loss is among events that "have proven 'too big to fail' banks are also too big to manage and too big to regulate," Brown, an Ohio Democrat, said in a Jan. 22 e-mail. "The question is no longer about whether these megabanks should be restructured, but how we should do it."

Brown and fellow Banking Committee member David Vitter, a Louisiana Republican, are considering legislation that would impose capital levels on the largest banks higher than those agreed to by the Basel Committee on Banking Supervision and the Financial Stability Board, which set global standards. Brown also plans to reintroduce a bill he failed to get included in Dodd-Frank or passed in the last Congress that would cap bank size and limit non-deposit liabilities.

The two senators have asked the Government Accountability Office to look into the economic benefits including lower borrowing costs that banks with more than $500 billion in assets receive as a result of federal deposit insurance, access to the Fed's discount window and investor perceptions that they'll be rescued in times of trouble.

No Consensus

Momentum for revisiting Dodd-Frank, whose Democratic authors Senator Christopher Doddand Representative Barney Frank are no longer in Congress, is driven by both parties. Still, lawmakers are nowhere near consensus on what approach to take -- whether raising capital standards, limiting the size of institutions or curbing subsidies.

The push by regulators may encourage Congress to take another look at the law, said Camden Fine, chief executive officer of Independent Community Bankers of America, which represents about 5,000 small lenders.

"I think there's going to be a synergy here between the regulators and Congress," said Fine. "If regulators call for new authority, Congress will look for that. I would say that between now and probably the end of 2015 or 2016 you're going to see some significant step by both Congress and regulatory agencies to rein in the big banks."

Fisher's Bull

The Dallas Fed's Fisher, who keeps a breeding bull named "Too Big to Fail" on his Texas ranch, proposed in a Jan. 16 speech that regulators be explicit about what kinds of banking the government will backstop. Deposit insurance and discount- window loans would be available only to a firm's commercial and consumer-banking operations. Fisher's proposal would push other risk-taking businesses, such as investment banking, away from government support, raising their cost of funding.
House Financial Services Chairman Jeb Hensarling said his panel will look at alternatives to the so-called liquidation authority in Dodd-Frank, which gives the Federal Deposit Insurance Corp. power to take over failing financial groups. He and fellow Republicans on the committee have argued that the plan keeps taxpayers on the hook for bailing out large banks because it lets the FDIC borrow from the Treasury to purchase a failing bank's assets and pay off its creditors.

"There is something fundamentally wrong in our nation if there are financial institutions that are deemed too big to fail and others too small to matter," Hensarling, of Texas, said in an interview.

Living Wills

Dodd-Frank and the nation's banking regulators already have taken steps aimed at limiting the risk that a large bank will fail. The Fed conducts annual stress tests on the 19 largest financial firms to determine whether they need to boost capital and limit dividends. Banks file "living wills" to the FDIC describing how they could be wound down. The Fed also is focusing on how boards monitor risk and set compensation.

Big banks and their representatives in Washington say such initiatives are evidence that Dodd-Frank is working and doesn't need an overhaul.

The notion that banks are "still somehow protected from market discipline" is "demonstrably false," Rob Nichols, CEO of the Financial Services Forum, a Washington-based lobbying organization, wrote in a rebuttal to Fisher published Jan. 28 in the Dallas Morning News.

System Strengthened

"Fisher and other breakup proponents overlook major provisions of the Dodd-Frank Wall Street Reform Act that effectively end the problem of 'too big to fail,' as well as significant action taken by large banks that has dramatically strengthened the U.S. financial system," wrote Nichols, whose group includes the heads of some of the world's largest banks, including Credit Suisse Group AG and Goldman Sachs Group Inc.

Breaking up large banks would put U.S. financial institutions at a competitive disadvantage, according to a report being published today by Hamilton Place Strategies, a Washington-based consulting firm founded by Tony Fratto, a White House and Treasury Department spokesman during the administration of George W. Bush.

"Ultimately, breaking up U.S. banks will not improve the safety of the global financial sector and would reduce U.S. influence over the financial sector globally," the firm wrote.

Jamie Dimon, CEO of JPMorgan, told clients in Germany Jan. 21 that regulators and banks should develop systems to let lenders go bust without damaging the world economy.

"We have to ensure big banks can be taken down without harming the public and at no cost to them," Dimon, 56, said at a panel discussion in Koenigstein, near Frankfurt.

Separation Rule

European regulators also are seeking ways to structure riskier activities outside of more traditional banking. Deutsche Bank AG and Credit Agricole SA are among European banks lobbying against proposals by a group led by Bank of Finland governor Erkki Liikanen to force large lenders to segregate some trading activities into separately capitalized units. The rule would apply to proprietary trading, unsecured loans to hedge funds and private-equity investments.

The 848-page Dodd-Frank Act, passed in 2010, sought to reduce the risk of a major bank failure in two ways. It orders the Fed to design higher capital and liquidity requirements and stress test bank portfolios, while also establishing a resolution regime that gives the FDIC wide latitude to wind down a failing institution if bankruptcy isn't an option.

The impact the collapse of Lehman Brothers Holdings Inc. had on world financial markets and the U.S. economy gives regulators reason to avoid future bankruptcies.

Friday Nights

The alternative, using the FDIC's liquidation authority, has its drawbacks. The law requires the approval of the Treasury secretary to shut down a large bank, bringing politics into the decision. It also would allow any failure of a large bank to be paid for

using Treasury funds, with the cost recouped through fees on the industry. Republicans oppose any use of Treasury funds even if repaid.

“Do you think there is a Treasury secretary ever born or yet to be born that would bring down -- like they do a community bank on a Friday night -- bring down Wells Fargo or Bank of America?” said the ICBA’s Fine. “Hell no. They would do exactly what they did four years ago.”

The resolution regime also could be overwhelmed if several large banks got into trouble at once, said Harvey Rosenblum, research director at the Dallas Fed.

Bank Liquidation

Dodd-Frank’s bank-liquidation rules “could work in one isolated large failure, but anything beyond that would be extremely difficult,” said Rosenblum, who has worked at the Fed since 1970. “We either have to cap their size or force these institutions to break themselves up.”

JPMorgan’s assets rose to $2.36 trillion at the end of 2012, from $1.48 trillion in the third quarter of 2007, according to company filings. Bank of America’s stood at $2.21 trillion compared with $1.58 trillion in the third quarter of 2007. Both New York-based JPMorgan and Charlotte, North Carolina-based Bank of America rescued failing financial companies in the crisis, becoming larger as a result.

Dodd-Frank seeks to curb the size of banks by prohibiting mergers that result in a company whose liabilities exceed 10 percent of the industry’s aggregate liabilities. That built on a 1994 law prohibiting a bank holding company from making an acquisition if it would result in an entity holding 10 percent or more of the total insured deposits of the U.S.

‘Better Solution’

Neither statute stops banks from getting bigger. They can expand their balance sheets beyond these limits through non- deposit liabilities such as repurchase agreements and commercial paper, or by increasing deposits and other liabilities through internal growth. Brown’s bill would set the ceiling on deposits and liabilities at 10 percent regardless of how it was reached.

“There is a strong and ongoing public debate going on whether or not the institutions should be broken up as a better solution or preferred solution,” Thomas J. Curry, who leads the U.S. Office of the Comptroller of the Currency, told the U.K.

Parliamentary Commission on Banking Standards Joint Committee on Jan. 24. Democrats and the administration of President Barack Obama may be loath to re-open the Dodd-Frank debate. Representative Maxine Waters of California, the House Financial Services Committee’s ranking Democrat, issued a statement in January taking issue with Hensarling’s assertion that Dodd-Frank “enshrined a ‘too-big-to-fail’ bailout scheme into law.”

‘Wiped Out’

On the contrary, Dodd-Frank "mandates the orderly liquidation" of a failed institution, "in which its executives are dismissed and its shareholders are wiped out," Waters said in an e-mailed statement. "The point of this process is to allow institutions to fail without causing catastrophic damage to the larger economy."

One dissenting member of her committee is Brad Sherman, a fellow California Democrat, who said he plans to reintroduce a bill requiring the Treasury secretary to compile a list of banks considered too big to fail and a year later break them up.
"It's not enough for current governmental leaders to declare we're not going to bail them out," Sherman said. "If an institution can credibly argue to some future president or some future Treasury secretary that if it goes down, it is going to take the economy with us, there's a significant possibility they're going to get bailed out."

Karen Shaw Petrou, who keeps track of legislation and regulation for the world's largest banks as a managing partner at Federal Financial Analytics in Washington, said she can't rule out the possibility of legislation. Beating on the big banks is one of the few areas where Republican and Democratic populists unite, she said.

Little Confidence

"This is going to be one of those instances where the left wing, of which there are a lot among House Democrats, and the right-wing Republicans join together," Petrou said. "I don't think potential legislation can be discounted."

Regulators such as the Fed may be motivated to do more, if only to preserve their powers. Dodd had so little confidence in the Fed's ability to oversee large banks that he sought, in a draft of his legislation in 2009, to strip the central bank of its supervisory authority.

Tarullo, the Fed governor in charge of supervision and regulation, has overhauled the central bank's approach. He created a task force known as the Large Institution Supervision Coordinating Committee, which draws on economic forecasters, computer modelers, payment-systems specialists and supervisors to look across several financial institutions at once to spot clusters of risk. As a result of the stress tests, the Fed now has more loan and trading-book information on the largest banks than ever before.

Website Crash

Still, Tarullo has expressed discomfort with large banks getting larger, saying in an October speech in Philadelphia that there's a case to be made "for specifying an upper bound."

While not mentioning a specific limit, Tarullo said he would recommend a "presumption of denial for any acquisition by any firm that falls in the higher end of the list of global systemically important banks." He also said Congress could limit large-bank growth by capping non-deposit liabilities.

Fisher of the Dallas Fed said in an interview that his Jan. 16 speech caused an unusual stir in banking circles.

After the text of his talk, "Ending 'Too Big to Fail': A Proposal for Reform Before It's

Too Late," was posted on the bank's website, Fisher said he was "flooded with notes from bankers around the country."

There was so much demand for the speech that the website crashed, he said. "This has never happened."