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'Too Big to Fail' Proves Too Difficult To Destroy; Plans may soften the blow of failures, but not fix the problem

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WASHINGTON - Despite an array of proposals to end "too big to fail," the concept is certain to survive regulatory reform.

Proposed solutions run the gamut from higher capital and liquidity requirements for large and complex banking companies - as well as enhanced oversight - to higher taxes and curbs on growth and risk-taking. While there is no doubt that such moves would soften the blow if a behemoth fell, none would eliminate the problem.

"It's naive to think 'too big to fail' is going to go away," said Gil Schwartz, a partner at Schwartz & Ballen LLP. Regulatory reform "may change the nature of the problem, but I don't think it will ever go away. It will always lurk in the shadows that an institution is too big to fail and the government won't let it fail."

The notion that certain banks are too big to fail has been around for a long time, at least since the rescue of Continental Illinois in 1984.

But it has never been as contentious as it is now, largely because the government spent hundreds of billions of taxpayer dollars to save some of the biggest banking companies in the wake of the financial crisis.

"The magnitude of the government aid in this situation has certainly made it far more difficult to have a credible position in the future that the government won't stand behind them," said Cornelius Hurley, a professor at Boston University School of Law.

Though the entire regulatory reform campaign, which began in earnest last June, has been billed as a way to end the de facto policy of too big to fail, the debate has veered to other issues, including ways to improve consumer protections and consolidate banking supervisory agencies.

The most recent direct attack on too big to fail is the so-called Volcker Rule, which would ban commercial banks from trading for their own account or owning or investing in hedge funds and private-equity pools. It would also limit overall size by means of a to-be-determined liability cap.

"Never again will the American taxpayer be held hostage by a bank that is too big to fail," President Obama said in announcing the plan on Jan. 21.

But observers said the plan, named after former Federal Reserve Board chairman Paul Volcker, who is now an economic adviser to the president, does not come close to solving the problem.

Though the proposed proprietary trading and activities ban could conceivably mean that some large institutions would have to divest or restructure securities units, not every banking company considered too big to fail does a significant amount of proprietary trading, including JPMorgan Chase & Co.

The proposed size limits, meanwhile, would apply only to future growth; they would not curtail institutions' current size.

"This new financial-sector size limit should not require existing firms to divest operations," Neal Wolin, the Treasury deputy secretary, testified at a Senate Banking Committee hearing last week. "But it should serve as a constraint on future excessive consolidation among our major financial firms ... . It should constrain the capacity of our very largest financial firms to grow by acquisition."

Sen. Jim Bunning, R-Ky., pointed out that, by targeting only future growth, the plan ignores current realities.

"If these firms are already too big to fail, and the last two years have shown that at least in the judgment of the Federal Reserve and Treasury that is the case, why should we not force them to get smaller in addition to stronger regulations?" Bunning asked. "How does letting a firm that is already too big to fail stay big ... how does it solve the problem?"

Sen. Robert Menendez, D-N.J., agreed. "You know, in the wake of the financial crisis, the surviving banks have actually grown bigger, not smaller," he said. "The Volcker Rule doesn't force existing banks to downsize."

Some regulators, however, said restrictions on risk-taking would help. New York Banking Superintendent Richard Neiman said that, if the ban on trading and dealing with hedge funds were applied retroactively, institutions would be safer and less likely to fail (and therefore less likely to need a bailout).

"It reduces the likelihood of failure by curtailing speculative activities," Neiman said. "To the same extent, it could prevent the growth of institutions to the extent they are being driven by those activities."

Some observers pointed to another proposal designed to curb the problem. An amendment in the House regulatory reform bill by Rep. Paul Kanjorksi, D-Pa., would let a new council of regulators, working with the Fed, break up healthy companies that pose a risk to the system.

But many observers doubt regulators would ever use that power.

"I just think it's too hard to know if a firm is risky and needs to be broken up," said Phil Swagel, a professor at Georgetown University and a former Treasury assistant secretary for economic policy in the Bush administration. "I just don't see it being a realistic tool because I think, when push comes to shove, regulators won't use it in the time that matters."

Richard Carnell, an associate professor at Fordham University School of Law and former Treasury assistant secretary for financial institutions, said the amendment "makes no practical difference."

"You can't use it until a firm poses a grave threat to the nation's financial stability," he said. "By then it's too late. The amendment is like a building permit you can use only during a hurricane."

Even if regulators were willing to force a banking company to make big divestitures, observers said, it would be difficult to know what size makes an institution "too big" or how to untangle certain activities from others in a company.

"It's so dangerous - it would be hard for them to do it unless they were prompted by a crisis," said Lily Claffee, a partner at Jones Day. "I think it would be rife with difficulties for them to use it."

Treasury officials have argued that other provisions - including higher capital and liquidity requirements - would also dilute the dangers posed by "too big" companies.

"We do have in our proposal a series of elements that we think create positive economic incentives for firms to shrink - tighter capital standards, leverage constraints, liquidity requirements - all of which will create economic incentives in the direction" of addressing the too big to fail problem, Wolin said in the Senate Banking hearing.

But observers said higher capital and leverage requirements would merely reduce the cost of a failure - not avert it.

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"I don't think you can ever have enough capital," Schwartz said. "I think what it does is lessen the potential losses. It doesn't guarantee an institution won't become a public burden."

To be sure, some analysts said higher leverage and capital requirements are the best way to handle the problem.

"I think it's very effective, more capital and more liquidity," said Paul Miller, a managing director at Friedman Billings Ramsey & Co.

But Mark Calabria, the director of financial regulations studies at the **Cato Institute,** argued that regulators already have the authority to require higher capital standards. "The discretion regulators have on capital standards is immense," he said. "The regulators could already do it, and didn't before. It's not a matter [of] they didn't have the power - it's [that] they had no grasp of it."

Beyond tackling too big to fail is what to do once a large company gets into trouble. Observers applauded an administration plan to give regulators greater authority to seize and unwind a failing company so large and complex that it poses a threat to the economy.

Neiman said such resolution authority could deter institutions from getting too large.

"We are always going to have institutions, because of their size or interconnectedness or the activities they perform ... , that would present systemic risk, ... if they failed, on day one, and that's why it's so critical that there be a system to appropriately unwind those institutions," he said. "I think that in itself will present a deterrent for institutions to grow that large, knowing they will be allowed to fail."

But resolution powers present their own problems. For one, they only come into play when a company is on the brink of failure - and do little to deter risk-taking or growth. For another, they can paradoxically reinforce investors' perception that some institutions will get different, potentially preferential, treatment from the government.

Jerry Hawke, a partner in the Arnold & Porter law firm and a former comptroller of the currency, said institutions will always be too big to fail unless the government ensures that creditors take significant losses.

"I tend to think we ought to be more tolerant about letting institutions fail," he said. "The problem is, no one defines what failure means. In many cases the creditors of an institution would come out with some cents on the dollar, and if a claimant gets 70 cents on the dollar rather than 100, that's no big deal."

The perception that creditors will be made whole or take only small losses has given large banks a big funding advantage. Curbing that is the key to ending too big to fail, some said. "Most of what has been proposed deals with the symptoms, not the cause," said Calabria. "So I'd say, why are these institutions so big? One is, they were able to fund themselves so that their debtholders believed they would be made whole ... ; you need to come up with a system where, if needed, debtholders have to take haircuts."

Hurley, the Boston University professor, agreed.

"You have to remove the perverse incentive, which is the funding advantage that all too big to fail institutions get from their creditors," he said. "Until they remove the narcotics from the system we are wasting our time."

The only true solution, many said, is for the government to reverse market expectations by letting some large institutions fail.

"Given what we have done in the past; going forward, the government has to prove it is willing to take those steps and [that] there are not institutions that are too big to fail," said Kevin Jacques, holder of the Boynton D. Murch chair in finance at Baldwin-Wallace College.

Until that day, too big to fail is here to stay. "I think we largely have to live with it," said Doug Elliott, a fellow at the Brookings Institution. "No sane policy person likes too big to fail, but all the suggestions

I've seen do more harm than good."