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Fed's Neel Kashkari Rolls Out Blueprint for Ending 'Too Big to Fail' Banks

Impact of 'Minneapolis Plan' unclear given Donald Trump's calls for less regulation

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Federal Reserve Bank of Minneapolis President Neel Kashkari on Wednesday recommended a hefty increase in capital requirements for the country's biggest financial institutions, a de facto call for breaking up the big banks.

The recommendations are part of a 50-page report that comes after a nearly yearlong effort by Mr. Kashkari to explore ways to end the problem of "too big to fail" banks, which could leave taxpayers on the hook if the financial system were to come under threat again.

Mr. Kashkari said at an event hosted by the Economic Club of New York that if his "Minneapolis Plan" is implemented, "We will have fewer mega banks, and there will be far less concentration in the banking system…. If there are any [too big to fail] banks left, they will be so well-capitalized that their risk of failure will truly have been minimized."

The consequences of the report, which is being sent to policy makers and to Congress, are unclear. President-elect Donald Trump stirred up anti-Wall Street sentiment but has also called for dismantling the 2010 Dodd-Frank regulatory-overhaul law that imposed tougher rules for the financial system.

Mr. Kashkari's proposal would require action by Congress. He said he doesn't know what the chances are of lawmakers or the president-elect pushing legislation based on his plan.

Mr. Kashkari's plan calls for banks with more than $250 billion in assets to hold common equity equivalent to 23.5% of risk-weighted assets. The equivalent leverage ratio would be 15%.

Those figures are multiples of current capital requirements and are aggressive when compared with other proposals aimed at raising such thresholds. But they are in line with a general push for new legislation sponsored by both Republicans and Democrats in Congress aimed at making the financial system safer by forcing banks to hold more capital.

The Financial Services Forum, a trade group representing the CEOs of the 16 largest financial institutions, released a statement criticizing Mr. Kashkari's plan for its potential to hamper economic growth.

“For those looking to accelerate economic growth and job creation, tripling bank capital levels—already double from precrisis levels—will make it much harder to meet those goals,” the statement said.

Mr. Kashkari acknowledged that the costs of his plan could lead to slower growth and higher interest rates for consumers. He also recognized that it would impose challenges for banks seeking a return on equity.

In an interview with The Wall Street Journal, he said “It’s not a public policy problem if [the big banks’] business model doesn’t work.” A subsequent breakup of the banks “does not concern me,” he explained.

Mr. Kashkari received support from other corners of the political spectrum. Sen. David Vitter (R-La.), whose own 2013 proposals to end too big to fail also included a minimum leverage ratio of 15%, was more supportive.

“By focusing on simple, targeted reforms like increased capital standards—which I’ve advocated for years—we can create real protections against future taxpayer-funded bailouts,” he said, suggesting reforms should go hand in hand with regulatory relief for smaller banks.

Mark Calabria, a Cato Institute financial-regulation expert and former Republican staffer, said the proposals were a “much needed jump start to the debate”.

“The post crisis response has clearly not ended [too big to fail],” Mr. Calabria added. “Whether the Minneapolis Fed has offered a workable solution remains to be seen,” he said.

Mr. Kashkari, a former top Treasury Department official during the financial crisis, has made ending “too big to fail” the cornerstone of his tenure at the regional bank since taking the helm in January. He announced his plan to explore how to make the banking system safer to much fanfare about a month after taking over the post.

The Minneapolis Fed has held numerous conferences on the topic since, with a number of well-known big bank critics—such as Stanford University’s Anat Admati and Massachusetts Institute of Technology’s Simon Johnson—proposing solutions that appear to have shaped Mr. Kashkari’s final conclusions.

In addition to higher capital requirements, Mr. Kashkari’s plan calls for the Treasury secretary to certify that a bank doesn’t pose a systemic risk to the financial system. For every year that Treasury cannot give such certification, a bank will face additional common equity requirements of up to 5% of risk-weighted assets each year, with a cap of 38%.

“We believe that these automatic increases in capital requirements will lead banks to restructure themselves such that their failure will not pose the spillovers that they do today and thus will not lead to bailouts,” the report says.

Other key components of the plan include a tax of at least 1.2% on large “shadow banks,” or financial institutions such as hedge funds and mutual funds, to discourage the use of debt. Mr. Kashkari also calls for regulatory relief for community banks.

The report says that if the recommendations are instituted, the chance of a financial crisis could be as low as 9%. Mr. Kashkari estimates that regulations imposed since the financial crisis have reduced the chance of another crisis from 84% to 67%.

Mr. Kashkari has often compared the trade-offs for a stronger banking system to heightened security protocols due to the threat of terrorism. For both, the risk can't be eliminated, but society needs to determine what costs they are willing to pay to minimize risk, he explained.

"Regulations can make the financial system safer, but they come with costs of potentially slower economic growth," he said in his speech Wednesday. "Ultimately, the public has to decide how much safety they want in order to protect society from future financial crises and what price they are willing to pay for that safety."