Too-big-to-fail too hard to solve

Craig Torres and Cheyenne Hopkins February 11, 2013

NEW YORK — 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 U.S. Sen. 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 Sen. 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., Bank of America Corp. and Wells Fargo & Co. — 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.

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 email. "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 Dodd and 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 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," Fine said.

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.

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.

"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.

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.