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How much debt is too much for 'too-big-to-fail' banks?

Provision capping bank debt can be easily evaded, policy analysts argue

By Ronald D. Orol, MarketWatch

WASHINGTON (MarketWatch) -- As the Senate takes up sweeping bank reform after the financial system's near collapse in 2008, a battle is brewing on Capitol Hill over whether legislators should limit the amount of borrowed money that the biggest and most important firms use.

Republicans and Democrats in the Senate are sparring over a provision approved as part of a mammoth House bank-reform bill that would cap the big firms' borrowing, called leverage, at a ratio of 15-to-1.

The leverage ratio measures the company's debt to its public equity; in other words if a firm had $1 billion in publicly-held stock, it could have debt - or be leveraged -- up to $15 billion under the 15-to-1 ratio limit.

The rationale behind such a move is to keep big banks from growing dangerously large so that if they fail, they won't cause collateral damage to the markets. During the height of the boom leading up to the financial crisis, many investment banks hiked their leverage to as high as 50-to-1.

'We prefer Congress not set the leverage limits because one size does not fit all.'

Scott Talbott, Financial Services Roundtable

"Big banks have leverage ratios of 15 to 1 right now, but you have to think about what is a sustainable level of debt when many large banks had 50-to-1 leverage ratios," said Heather McGhee, director at DEMOS, a public-policy advocacy organization in Washington and New York.

The Obama administration doesn't back the House plan, and it doesn't have a companion sponsor in the Senate, which will likely begin considering a broad bank-reform bill in late January or early February.

The current Senate bank bill would leave it to a newly formed consolidated bank regulator, made up of other financial agencies, to identify what leverage limits are appropriate.

Sens. Mark Warner, D-Va., and Bob Corker, R-Tenn., two Senate Banking Committee members charged with reaching a bipartisan deal on systemic risk issues, aren't working on setting a statutory limit on leverage, according to people familiar with their efforts.

Nevertheless, it's possible a leverage limit -- popular among consumer groups -- could become one part of a much bigger package of "too-big-to-fail" reforms expected to include a mechanism -- with funding -- to dismantle a failing big bank so that its collapse doesn't ripple through the markets.

"High leverage has been shown to have been one of the best predictors of major financial firms falling into distress or needing government support during the current crisis," said Rep. Jackie Speier, D-Calif., the provision's sponsor.

"I believe that it is a mistake to leave all discretion in how to accomplish that task to the primary regulators," she said. "Regulators had the power to avert much of the current crisis, but they bought in to the collective myopia and failed to exercise that power."

Two Terror Suspects Arrested in New York

Two men who traveled to Pakistan with Najibullah Zazi were arrested early Friday morning in New York. Video courtesy of Fox News.

Unintended consequence

Backers of the bill privately worry about whether it will survive the process of reconciling the Senate and House versions of bank reform, which isn't expected to come to pass until the spring.

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Graham Steele, Public Citizen

Nevertheless, critics of the leverage limit argue that "boots-on-the-ground" bank regulators are in a better position to identify how much leverage and risk a particular financial institution can handle.

"We prefer Congress not set the leverage limits because one size does not fit all. We think the regulators, who are boots-on-the-ground, should continue to set limits," said Scott Talbott, senior vice president at the Financial Services Roundtable in Washington. "Regulators need the flexibility to adjust based on different companies they regulate."

Some worry an across-the-board leverage cap for big banks would have the effect of discouraging lending to consumers and businesses -- ironically, just as lawmakers, the White House and public press the institutions to offer more loans.

"This is totally in contraction to the 'we-want-you-to-lend' message Congress is also sending," said Nancy Bush, managing member of NAB Research in Annandale, N.J. "The House is putting the horse ahead of the cart here; leverage limits should be set up by the regulator."

For his part, Public Citizen policy analyst Graham Steele doesn't believe leverage limits at big banks would discourage lending. He contends most of the unusually high leverage was taken on by investment institutions, or investment banking divisions of commercial banks.

Retail bankers didn't hike their debt loads to dangerous levels as a means of expanding their lending divisions, he said, adding: "Most of the significant increase in leverage over the last few years was to accommodate other activities, such as derivatives investments, not retail lending."

Steele argues that bank regulators failed in the past and should not be given the responsibility to set leverage limits again. He noted that the Senate bill only takes major steps to clamp down on leverage during periods of economic stress.

The Speier provision, in Steele's view, is counter-cyclical in that it requires institutions to limit their leverage during strong economic periods so that they are not as likely to damage the markets when the economy turns sour.

Steele added that he is worried that a statutory cap on big bank leverage could be easily evaded by large financial institutions, which can move assets and liabilities easily off balance sheet.

"A big financial institution's ability to stash those liabilities elsewhere is a problem," said Steele. "Citigroup had very little on its balance sheet, it had everything, derivatives, credit default swaps, and all its leverage stashed in its off-balance sheet units."

Lessons of 2008

McGhee said there is a consensus of conservatives and progressives that banks should not be over-leveraged.

"We should have limits on leverage in statutory language," McGhee said. "There are a lot of lessons from last year's crisis that give us enough information about the flaws in our banking system that we can agree on some hard and fast limits on leverage."

She contends that the amount of debt taken on by a group of large investment banks increased to as much at 50 to 1 after the Securities and Exchange Commission in 2004 dropped a regulation limiting the amount of debt they could take on.

Large investment banks registered with the SEC at the time -- including Merrill Lynch, Morgan Stanley (NYSE:MS) , Goldman Sachs (NYSE:GS) , Lehman Brothers and Bear Stearns -- sought an exemption for their brokerage units from the requirement that they keep billions in reserves as a cushion against losses.

Lehman and Bear Stearns collapsed in 2008, while Merrill Lynch fell into a weakened state before its controversial acquisition by Bank of America (NYSE:BAC) .

Alternatively, another approach is gaining traction on Capitol Hill, but not yet with any member of the banking committee.

Sens. John McCain, R-Ariz., and Maria Cantwell, D-Wash., on Dec. 16 introduced legislation that could break up the big institutions by prohibiting retail banks with depositors from engaging in investment-banking activities, such as underwriting securities.

If it were to become law, it could force J.P. Morgan Chase (NYSE:JPM) to divide into two companies, and Bank of America's acquisition of investment bank Merrill Lynch. could be unwound. The bill has four Democratic co-sponsors.

William Poole, senior fellow at the Cato institute, said he would prefer an approach to limit leverage even more -- perhaps by imposing a debt to equity ratio of 10-to-1.

Critics say this could end up putting some big banks in a difficult position by forcing them to sell assets or raise capital. However, Poole downplays such concerns: "They can grow if they raise [equity] capital. You don't want them to grow at the expense of risking another financial crisis."

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