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Poole on fixing TBTF

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William Poole, the last President of the St. Louis Fed and now with the Cato Institute, has a good piece on fixing the TBTF problem in a recent issue of the Financial Analysts Journal. Based on a speech given last April, it's still highly relevant.

Poole doubts that new resolution authority will end TBTF. When push comes to shove, regulators are more likely to bail out the next AIG or Lehman rather than attempt an "orderly" wind down, even if they have expanded authority to resolve holding companies.

Poole says four problems must be solved:

> First, many firms have too little capital relative to the risks they run. Unfortunately, capital inadequacy is often revealed only after the fact. We need arrangements that force banks to hold more capital than might seem necessary. Second, banks need long-maturity capital that cannot run. Third, we need to rely more on market discipline to deny funds to banks deemed risky. Fourth, when a bank needs to be restructured, the bank, rather than the federal government, should manage the restructuring.

Perhaps the best way to reduce leverage would be to get rid of the tax incentive to max it out, ending the deductibility of interest on business and personal tax returns. Easier said than done, of course. The lobbying effort to stop such a reform would be huge. So Poole proposes that the transition be "smoothed."

> …interest deductibility could be phased out over the next 10 years. Next year, 90 percent of interest would be deductible; the following year, 80 percent would be deductible, and so forth, until interest would no longer be deductible at all. The same reform would apply to all business entities; partnerships, for example, should not be able to deduct interest if corporations cannot.
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> With this simple change, the federal government would encourage businesses and households to become less leveraged. We have learned that leverage makes not only individual companies more vulnerable to failure but also the economy less stable. We use tax laws all the time to promote socially desirable behavior; eliminating the deductibility of interest would reduce the risk of failure of large companies—especially, large firms—and thereby reduce the collateral damage inflicted by such failures.

As for dealing with capital inadequacy and maturity mismatch, Poole says banks should be forced to hold "a substantial block of subordinated long-term debt in their capital structure." To discourage growth of large firms, a bank with total assets over a certain threshold…

> …would have to issue subordinated debt equal to 10 percent of its total liabilities. The debt would consist of 10-year uncollateralized notes that were subordinated to all other debt obligations of the bank. With 10-year notes equal to 10 percent of the bank's total liabilities, the bank would have to refinance one-tenth of its subordinated debt every year, equal to 1 percent of its total liabilities. The subordinated debt would be in addition to existing requirements for equity capital.
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> Subordinated debt has several important advantages. We have seen that banks do not have an adequate cushion against losses under current capital requirements. If taxpayers are to be expected to stand behind our giant banks, they deserve a larger cushion against the banks' mistakes. More importantly, **because banks would have to go to the market every year to sell new subordinated debt, they would have to convince the market that they are safe. A bank that found selling new subordinated debt too expensive would have to shrink by 10 percent.**
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> Restructuring a bank at an annual rate of 10 percent is perfectly feasible, and the restructuring would be managed by the bank and not by the government.
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> A subordinated debt requirement has a significant advantage over a higher equity capital requirement, which is one of the regulatory changes being discussed. A subordinated debt requirement entails

> much more market discipline because a bank must either go to the market every year to replace maturing debt or shrink. If a bank's prospects appear poor to investors, its stock price will decline and it may be unable to sell more equity. But it is not forced to shrink under these circumstances, nor will regulators necessarily force a bank to shrink. Market discipline through subordinated debt would be much more rigorous than any discipline regulators are likely to apply.

Poole is basically in Sheila Bair's camp about forcing creditors to face losses. Bair is a supporter of the Miller-Moore amendment to the financial reform bill, which would give FDIC the power to impose a haircut on secured creditors of a large financial firm that ends up in receivership. That's a good idea and I hope it's signed into law.

But it's still a reactive way to shrink big banks. What we need are pro-active solutions that force banks to shrink *before* they get into deep trouble. Poole says his idea would accomplish this. I invite reader comments on whether it would or not…

There's more in the article.