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‘Too Big to Fail’ Remains Very Real

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Prominent voices within the financial sector are increasingly insisting on one point: We have ended “too big to fail.” The idea is simple: through a combination of legislation (the Dodd-Frank legislation of 2010) and supportive regulation (particularly regarding how big banks would be handled in the event of “liquidation”), very large financial institutions are no longer perceived by investors to be too big to fail.

Unfortunately, while tempting, this idea is completely at odds with the facts. The market perception that some financial institutions are “too big to fail” is alive and well. If you want to remove that perception, you need to break up our biggest banks.

In a high-profile paper prepared recently at the behest of the Securities Industry and Financial Markets Association (Sifma), the lobbying group for the securities industry, Federal Financial Analytics Inc. argues that “too big to fail” has effectively been ended.

“U.S. bank holding companies and other financial services firms, regardless of size or the nature of their operations, can no longer be rescued at long-term cost to the federal government or otherwise supported in ways that undermine meaningful market discipline.” (From the first paragraph of the executive summary.)

The implication of this report is that there is no need to push for further reforms on this dimension. But when I discussed the specifics of this issue on a panel at George Washington University last Friday with Karen Shaw Petrou, an author of that report, she conceded that creditors still believe that the government stands behind very large bank holding companies and other big financial companies. (There was C-Span coverage of the panel discussion.)

Ms. Petrou’s report deals with what the law and regulations could mean — under her interpretation, which seems close to the Sifma line (although Ms. Petrou speaks only for herself). But we should be more concerned with how the rules are actually understood by investors in financial markets.

You can theorize that "too big to fail" should have been removed by the recent reforms or will be eliminated by the passage of time. But as a practical matter — looking at what investors really believe — "too big to fail" is still with us. This implicit government guarantee lowers the funding costs for very large financial institutions because investors are convinced that debt issued by these firms is less risky than, for example, debt issued by small and medium-size banks. Ms. Petrou agreed with me on Friday that this is the current situation, although she also argues that there are additional reasons why big banks have a funding advantage (such as more liquidity in the market for their debt).

Over all, I side with Richard Fisher and Harvey Rosenblum of the Dallas Fed, who argue that "too big to fail" is very much here to stay under the current arrangements (see this recent piece I wrote about their work).

In effect, the government is providing a form of insurance that encourages financial institutions to become even bigger — and thus even more likely to be protected by some combination of the Federal Reserve, the Treasury and other agencies. This is an unfair, nontransparent government subsidy that encourages excessive risk-taking and creates a very large potential downside for the nonfinancial side of our economy.

Ms. Petrou points out that there are new legal barriers to some forms of bailout. That's correct, but the general machinery of potential support — for example, from the Federal Reserve — remains absolutely intact. Sometimes this is discussed in terms of "liquidity" support only, but the line can become blurred between liquidity support and helping a nearly insolvent financial institution. When the Federal Reserve also has the ability to inflate asset prices — for example, through conventional or unconventional monetary policy (including buying assets directly) — this distinction may sometimes become meaningless.

My conversations with senior officials, both recently retired and currently in place, confirm that they are of one mind on the key issue. When the choice is between global calamity on the one hand and unpalatable, unpopular and perhaps even illegal support for big banks on the other hand, these officials expect to go with the bailout.

Market participants are smart to understand this.

The question is how to take this choice off the table — or at least to make it significantly less probable that we ever reach such a decision point.

In an e-mail exchange on these issues, Ms. Petrou sent this statement:

Just because markets think they'll get bailed out doesn't make it so. This is one more case of markets getting it wrong and doing so with systemic consequence. Regulators should finalize the U.S. resolution regime and, as they do, make it very, very clear what the law says and how much it hurts so that markets prepare to take risk, not continue to expect bailouts that not only shouldn't come, but also won't, at least not here.

In a recent speech, "On Being the Right Size," Andrew Haldane from the Bank of England suggests a different emphasis for how we move forward.

It is not the case that the Dodd-Frank reforms were "the biggest kiss" to Wall Street (as Mitt Romney suggested in the presidential debates). Prominent figures on Wall Street fought fiercely against the broad contours of financial reform legislation in 2009-10 and fight now on every line of every detailed regulation; their estimated 3,000 to 5,000 lawyers and lobbyists work very hard and earn a great deal of money for a reason. This is not any kind of kiss that they want.

In the Haldane view — with which I fully concur — the Dodd-Frank changes were steps in the right direction, including the Volcker Rule (limiting what banks can do) and the new resolution authority. The

latter empowers the Federal Deposit Insurance Corporation to create rules governing how any financial institution can fail — with a view to imposing losses on creditors and avoiding broader disruption to financial markets.

The F.D.I.C. has worked hard on resolution issues — and it is no criticism to point out that these rules are as yet unproven and not fully believed by the markets. In the absence of a cross-border resolution framework, these rules also do not adequately cover what would happen if a global megabank went down. (I'm a member of the F.D.I.C.'s Systemic Resolution Advisory Committee; this is unpaid work and our meetings are televised.)

The point is to have multiple fail-safes in the system — do not rely on any one reform too much. You really do not know what will prove effective, particularly as the financial system continues to evolve and the nature of risks changes.

As Mr. Haldane emphasizes, it is therefore entirely complementary to propose a cap on the size of the largest financial institutions.

We need to have a credible commitment to let any financial institution fail — in the sense that it will go out of business, wiping out shareholders and imposing losses on creditors.

But any promise for global megabanks that we would "just let them fail" is completely hollow. Standard or even modified bankruptcy procedures are not a credible threat because of the damage this would cause to other financial institutions and to confidence around the world.

Make banks and other financial institutions small enough and simple enough to fail — this is the point stressed by Messrs. Fisher and Rosenblum.

As Mr. Haldane documents, when measured properly, there are no economies of scale for banks over $100 billion in total assets. As a society, we are not losing anything by imposing a size cap on our largest banks, which currently have assets in excess of $2 trillion. Of course, there are private benefits that are being lost — meaning lower subsidies for large financial firms and the powerful people who run them.

But we should welcome, not mourn, the elimination of such subsidies.