POLICY FOCUS

Ending 'Too Big to Fail'

RECIPES FOR RATIONAL GOVERNMENT FROM THE INDEPENDENT WOMEN'S FORUM

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WHAT YOU NEED TO KNOW

Five years ago, President Obama signed into law the Dodd-Frank Act, a measure aimed at abolishing the de facto policy of letting certain financial institutions become and/or be treated as "too big to fail" (TBTF). Most analysts agree that TBTF played a significant role in the 2008 financial crisis. Unfortunately, Dodd-Frank did not end TBTF. In fact, it effectively gave the policy an official imprimatur.

More specifically, Dodd-Frank classified America's largest bank-holding companies (those with $50 billion or more in assets) as "systemically important financial institutions" (SIFIs), and it empowered federal authorities to give non-bank financial firms the same designation. While SIFIs face tougher regulations than their smaller competitors, there is ample evidence that their TBTF status — now formally recognized by Washington — continues to deliver a major funding advantage. As for Dodd-Frank's new resolution authority, which was designed to help the government wind down a failing SIFI and prevent another crisis, it could easily be used as a mechanism for creditor bailouts of the kind we saw in 2008.

If policymakers really are serious about ending TBTF, they could start by (1) changing the SIFI-designation process, (2) supplementing or replacing Dodd-Frank's resolution authority with new bankruptcy provisions, (3) raising capital requirements for the biggest banks, and (4) reducing or eliminating debt subsidies in the tax code. These reforms would create a more equitable, balanced, and healthy U.S. financial system.

WHY YOU SHOULD CARE

The too-big-to-fail (TBTF) policy distorts financial markets, reduces competition, and damages economic growth. For example:

- **It creates implicit government subsidies for the largest financial institutions.** The International Monetary Fund has calculated that, in 2012, the TBTF borrowing advantage enjoyed by America's globally active "systemically important banks" amounted to a subsidy of between $15 billion and $70 billion.
- **It encourages the big banks to engage in riskier activities.** A 2014 New York Fed study confirmed that "a greater likelihood of government support leads to a rise in bank risk-taking." This increases the potential for crises and bailouts.
- **It promotes crony capitalism.** Under Dodd-Frank, America's financial giants have essentially been transformed into heavily regulated but highly profitable public utilities. As former Federal Reserve governor Kevin Warsh has noted: "If the government chooses select firms to be public utilities atop the business of banking, it is very difficult for the other 7,000 banking institutions to lend and compete. That is an obstacle to economic growth."

America needs a safer, more competitive financial system that promotes responsible lending and balanced growth rather than bubbles and bailouts.

MORE INFORMATION

What Is 'Too Big to Fail'?

There has never been an explicit too-big-to-fail (TBTF) policy in U.S. law or regulations. But in the quarter-century leading up to the 2008 financial crisis, the federal government created a general perception that it would, if necessary, intervene to prevent the collapse of "systemically important" banks and other firms.

Many analysts have pinpointed the 1984 federal rescue of Continental Illinois (a commercial bank) as the first large-scale financial bailout of the modern era. Subsequent bailouts — most notably, those of Long-Term Capital Management (a hedge fund) in 1998 and of Bear Stearns (an investment bank) a decade later — cemented the belief among investors that certain companies were protected by an unofficial government safety net. This had a major impact on risk tolerance and borrowing rates in the credit markets. For example, New York Fed economist João Santos has demonstrated that, between 1985 and 2009, America's largest banks benefited from reduced funding costs because of their TBTF status.

In September 2008, a burgeoning crisis in U.S. housing and financial markets prompted Washington to orchestrate bailouts of Fannie Mae and Freddie Mac (the government-backed mortgage firms) and AIG (an insurance company). Amid these bailouts, however, federal officials chose to let Lehman Brothers declare bankruptcy, a decision that contributed to widespread panic on Wall Street. Congress responded by passing the Troubled Asset Relief Program, which became known simply as "the bank bailout."

Needless to say, the events of 2008 caused bailout expectations to surge. Indeed, the International Monetary Fund has calculated that the implicit TBTF subsidies — i.e., the borrowing advantages — enjoyed by America's top banks were significantly larger during the crisis years (2008–10) than they were during the years prior (2006–07).

Why Dodd-Frank Didn't Solve the Problem

Americans of all political stripes recognize the inherent danger and unfairness of letting certain financial firms become and/or be treated as TBTF. By giving such firms implicit subsidies and bailout guarantees prior to the 2008 meltdown, the federal government encouraged them to take greater risks and overload on debt.

Ending TBTF was ostensibly the main goal of the Dodd-Frank Act, which President Obama signed into law on July 21, 2010. Dodd-Frank classified all bank-holding companies with at least $50 billion in assets as "systemically important financial institutions" (SIFIs), and it authorized a panel of federal regulators to identify non-bank financial firms as SIFIs. To date, four non-bank firms have received a SIFI designation. One of them — the insurance giant MetLife — is suing to overturn it. While SIFIs face tougher regulations than other companies, they conceivably benefit from implicit funding subsidies, because investors view "SIFI" as synonymous with "TBTF." In the words of former Fed governor Kevin Warsh: "By sanctioning some list of too-big-to-fail firms — and treating them different than the rest — policymakers are signalling to markets that the government is vested in their survival."

Dodd-Frank also established a new "orderly liquidation authority" (OLA) to seize and wind down any firm whose failure is deemed a threat to financial stability. Some argue that this eliminates TBTF. Yet University of Pennsylvania law professor David Skeel and others have shown that the OLA actually "perpetuates" TBTF. For one thing, Dodd-Frank allows the Federal Deposit Insurance Corporation (FDIC) to bail out certain creditors of a failing firm as part of the resolution process. It also allows regulators to offset the cost of such a bailout by slapping a "surcharge" on healthy firms. NYU finance experts Viral Acharya, Barry Adler, Matthew Richardson, and Nouriel Roubini believe this "leads to a free rider problem" that "will encourage even well-managed banks to take excessive risk."

In short: Whatever else it accomplished, Dodd-Frank did not end TBTF. Just ask former Fed chairman Ben Bernanke. Or current Fed governor Daniel Tarullo. Or former Obama Treasury secretary Tim Geithner. Or the International Monetary Fund, which reckons that implicit TBTF subsidies for America's top banks were substantially larger in 2011 and 2012 than they were in 2006 and 2007.

What Dodd-Frank *did* do is make it harder for smaller financial institutions to compete with the SIFIs. Consider what has happened to America's community banks. Harvard scholars Marshall Lux and Robert Greene estimate that, between mid-2010 and mid-2014, community banks saw their share of total U.S. banking assets fall by more than 12 percent, with the smallest community banks witnessing almost a 19 percent decline. By comparison, the five largest U.S. banks "control nearly the same share of U.S. banking assets as they did in the fiscal quarter before Dodd-Frank's passage." These findings, write Lux and Greene, "appear to validate concerns that an increasingly complex and uncoordinated regulatory system has created an uneven regulatory playing field that is accelerating consolidation for the wrong reasons."

Four Sensible Reform Ideas

The true test of Dodd-Frank will not occur until the next financial crisis. Some Republicans still hope to repeal the law, but that seems unlikely in the near term. A more realistic approach would be for Congress to revise or move beyond Dodd-Frank by adopting the following reforms.

(1) Change the SIFI-designation process. By making $50 billion in assets the threshold for automatic designations of bank-holding companies, Dodd-Frank ensured that the SIFI club would include plenty of non-systemic institutions. It is both unfair and illogical for the government to classify and regulate such banks as TBTF. Thus, a Bipartisan Policy Center task force has proposed raising the threshold to $250 billion. That would be a good start. Lawmakers should also eliminate SIFI designations for non-bank firms. The current system is arbitrary and opaque — former FDIC official Paul Kupiec has complained that it "makes a mockery of property rights and due process" — and it threatens to exacerbate TBTF while distorting industries such as insurance.

(2) Supplement or replace Dodd-Frank's resolution authority with new bankruptcy provisions. The OLA is a deeply flawed (and constitutionally dubious) vehicle for improving financial stability. Rather than make banking safer, it has created a new bailout mechanism and increased moral hazard. America needs a less discretionary, more predictable regime for winding down failed institutions. Members of the Hoover Institution's Resolution Project have outlined a series of reforms that would establish such a regime as "Chapter 14" of the U.S. bankruptcy code. These reforms could either supplement Dodd-Frank's OLA (as the Hoover authors suggest) or — better yet — replace it.

(3) Raise capital requirements for the largest banks. When the government raises capital requirements, it compels financial institutions to hold more equity relative to their assets.

Bank lobbyists argue that this reduces lending. But Stanford economist Anat Admati and other analysts have demonstrated that steeper equity requirements are perfectly compatible with a healthy and robust financial system. As FDIC vice chairman Thomas Hoenig recently observed, "Banks with stronger capital positions maintain *higher* levels of lending over the course of economic cycles than those with less capital. Additionally, better capitalized banks compete favorably in the market and survive economic shocks without failing or requiring bailouts" (emphasis added). In other words, there is no automatic trade-off between safety and efficiency. Raising and simplifying capital requirements could improve both.

(4) Reduce or abolish debt subsidies in the tax code. Among its many deficiencies, the U.S. tax system heavily favors debt over equity, thereby encouraging firms to borrow excessively. Indeed, both the Congressional Budget Office and the Treasury Department have estimated that the effective marginal tax rate (EMTR) on debt-financed corporate investment is more than 40 percentage points lower than the EMTR on equity-financed corporate investment. And while corporate-debt subsidies are not unique to America (they can be found in rich nations across the world), a 2007 Treasury report showed that "the United States has the greatest disparity between debt and equity EMTRs in the OECD." Shrinking or eliminating debt subsidies would help discourage overleveraging. Of course, it would also raise the corporate-tax burden — which is why it should be done as part of a broader tax reform that simplifies the system and dramatically reduces statutory rates.

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These reforms would give us a financial system with fewer distortions, less moral hazard, and much better safeguards against debt-fueled asset bubbles. Over time, they would help us end TBTF once and for all.

How Dodd-Frank Helps Goldman Sachs

Speaking to an investor conference this past February, Goldman Sachs CEO Lloyd Blankfein made a telling comment about the impact of recent financial regulations. "More intense regulatory and technology requirements have raised the barriers to entry higher than at any other time in modern history," Blankfein said. "This is an expensive business to be in, if you don't have the market share in scale." The likely future of finance, he added, is one in which "only a handful of players" can "effectively compete on a global basis."

Taking note of Blankfein's remarks, the *Wall Street Journal* editorial page lamented that "powerful government mainly helps the powerful."

Indeed, while Dodd-Frank saddled America's largest banks with new regulatory costs, it also solidified their dominant position atop the financial industry. A firm such as Goldman has the resources both to comply with stricter regulations and to shape those regulations through its lobbying efforts. Many smaller firms do not.

To be sure, the big banks are not *happy* about shouldering a heavier regulatory burden, but Dodd-Frank has reinforced their privileged status and confirmed that the government still considers them "too big to fail."

WHAT YOU CAN DO

You can help build support for ending "too big to fail" and creating a safer, more competitive financial system.

- **Get Informed:** Learn more about Dodd-Frank and financial regulation. Visit:
  - The Independent Women's Forum
  - The International Monetary Fund
  - The Federal Reserve Bank of New York

- **Talk to Your Friends:** Help your friends and family understand these important issues. Tell them about what's going on and encourage them to join you in getting involved.

- **Become a Leader in the Community:** Get a group together each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.

- **Remain Engaged Politically:** Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

ABOUT THE INDEPENDENT WOMEN'S FORUM

The Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility.

IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.

We rely on the support of people like you! Please visit us on our website www.iwf.org to get more information and consider making a donation to IWF.

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